

STATE OF ALABAMA
DEPARTMENT OF INSURANCE
MONTGOMERY, ALABAMA

Report of Examination

of

**BALDWIN MUTUAL INSURANCE COMPANY,
INCORPORATED**

Foley, Alabama

As Of

December 31, 2002

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STATE OF ALABAMA

COUNTY OF BALDWIN

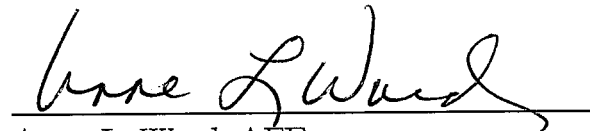
Anne L. Ward, being first duly sworn, upon her oath deposes and says:

THAT she is an examiner appointed by the Commissioner of Insurance for the State of Alabama;

THAT an examination was made of the affairs and financial condition of *BALDWIN MUTUAL INSURANCE COMPANY, INC.*, for the period of January 1, 1998 through December 31, 2002;

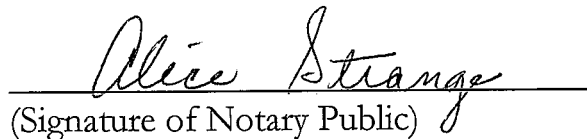
THAT the following 81 pages constitute the report thereon to the Commissioner of Insurance of the State of Alabama;

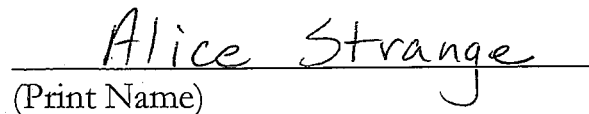
AND THAT the statements, exhibits and data therein contained are true and correct to the best of her knowledge and belief.



Anne L. Ward, AFE
(Examiner-in-Charge)

Subscribed and sworn to before the undersigned authority this 3rd day of November, 2004.


(Signature of Notary Public)

 Notary Public
(Print Name)

in and for the State of Alabama.

My Commission expires 4-6-06.



BOB RILEY
GOVERNOR

STATE OF ALABAMA
DEPARTMENT OF INSURANCE
FINANCIAL/EXAMINATION DIVISION

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November 3, 2004
Foley, Alabama

Honorable Walter A. Bell
Commissioner of Insurance
State of Alabama
Department of Insurance
201 Monroe Street, Suite 1700
Montgomery, Alabama 36104

Dear Commissioner:

Pursuant to your authorization and in compliance with the statutory requirements of the State of Alabama and the resolutions adopted by the National Association of Insurance Commissioners, a full scope financial and market conduct examination as of December 31, 2002, has been made of the affairs and financial condition of

BALDWIN MUTUAL INSURANCE COMPANY, INCORPORATED

at its home office located at 315 East Laurel Avenue, Foley, Alabama 36535. The report of examination is submitted herewith.

Where the description "Company" or "BMIC" appears herein, without qualification, it will be understood to indicate *Baldwin Mutual Insurance Company, Incorporated*.

SCOPE OF EXAMINATION

A full scope combined financial and market conduct examination was authorized pursuant to the instructions of the Alabama Insurance Commissioner and in accordance with the statutory requirements of the *Alabama Insurance Code* and the resolutions, regulations and bulletins of the State of Alabama, Department of Insurance (ALDOI); in accordance with the applicable procedures and guidelines promulgated by the National Association of Insurance Commissioners (NAIC); and in accordance with generally accepted examination standards in connection with the verification of assets and determination of liabilities.

The Company was last examined for the five-year period ended December 31, 1997, by examiners representing the ALDOI. The current examination covers the intervening period from the date of the last examination through December 31, 2002, and was conducted by examiners from the ALDOI. Where deemed appropriate, transactions subsequent to 2002, were reviewed.

The examination included a general review of the Company's operations, administrative practices, and compliance with statutes and regulations. Corporate records were inspected. Income and disbursement items for selected periods were tested. Assets were verified and valued, and all known liabilities were established or estimated as of December 31, 2002, as shown in the financial statements contained herein. However, the discussion of assets and liabilities contained in this report has been confined to those items which resulted in a change to the financial statements, or which indicated a violation of the *Alabama Insurance Code* and the ALDOI's rules and regulations or other insurance laws or rules, or which were deemed to require comments and/or recommendations.

A signed certificate of representation was obtained during the course of the examination. In this certificate, management attests to have valid title to all assets and to the nonexistence of unrecorded liabilities as of December 31, 2002. A signed letter of representation was also obtained at the conclusion of the examination whereby management represented that, through the date of the examination report, complete disclosure was made to the examiners regarding asset and liability valuation, financial position of the Company, and contingent liabilities. An office copy of the Company's filed Annual Statement for 2002, was compared with or reconciled to account balances with respect to ledger items.

The market conduct phase of the examination consisted of a review of the Company's territory, plan of operation, operations/management, complaint handling, marketing and sales, producer licensing, underwriting and rating, claims, and privacy policies and

practices.

The examination was conducted concurrently with the examination of Gulf Coast Title Insurance Company, Incorporated (GCTIC), the Company's majority-owned subsidiary.

ORGANIZATION AND HISTORY

The Company was incorporated on July 21, 1921, under the laws of the State of Alabama as "Baldwin Mutual Insurance Company, Incorporated."

The objectives or purposes of the incorporation, as set forth in the Certificate of Incorporation, were to issue policies and enter into contracts of insurance and to reinsure or accept reinsurance on any portion thereof for fire, liability, disability, automobile, steam boiler, use and occupancy, title and miscellaneous insurance, which are not prohibited by statute or at common law from being the subject of insurance, excepting life insurance.

The Company was organized as a mutual insurance corporation and continues to operate under the mutual plan with no capital stock. No amendments to the Articles of Incorporation occurred during the current examination period. On February 26, 1998, by a unanimous vote of the policyholders, Section 4.A. of Article VI of the By-Laws was changed to include the position of Chairman of the Board.

At the December 31, 2002 examination date, the Company's Annual Statement reflected *Surplus as regards policyholders* of \$8,291,911.

MANAGEMENT AND CONTROL

Membership

The membership of the Company shall consist of the persons and organizations having insurance herein. The Annual Meeting of the members shall be held beginning at 2:00 P.M. at the Home Office on the last Thursday in February of each year. Each member shall be entitled to one vote. No proxies shall be voted. Members present and voting shall constitute a quorum at any membership meeting.

Board of Directors

The By-Laws provided that the corporate powers of the Company shall be vested in

the Board of Directors. Except as otherwise provided, the Board of Directors shall have general management and supervision of the business and affairs of the Company.

The Board shall be composed of nine persons elected from the membership at the Annual Meeting. Members of the Board shall be elected for a term of three years with one-third of the terms expiring each year.

The members of the Board of Directors serving at December 31, 2002, were as follows:

<u>Director/Residence</u>	<u>Principal Occupation</u>
Arthur Abel Holk Foley, Alabama	Chairman of the Board
Ralph Timothy Russell Foley, Alabama	President, and Comptroller of the Company
Clair Dean Hansen Foley, Alabama	Retired County Commissioner
Samuel Francis Parker Foley, Alabama	Retired Certified Public Accountant
Carl Emery Johnson Foley, Alabama	Certified Public Accountant
Paul (NMI) Kaiser, Jr. Foley, Alabama	Retired Farmer
William Henry Riemer Elberta, Alabama	Retired Farmer
Paul Frederick Schultz Foley, Alabama	Retired Petroleum Distributor

It was noted that long time Board member, James Walter Clark, died during 2001, and had not been replaced at the examination date. The Company's By-Laws stipulate that an empty position can be filled for the unexpired term by the remaining directors.

The minutes of the Board of Directors did not reflect evidence that the independent auditor's report had been presented to the BOD in accordance with Article VII of the Company's By-Laws.

Officers

The By-Laws provided that the annual meeting of the Board of Directors shall be held immediately after the annual meeting of the members, whereby it shall elect a chairman, a president, one or more vice presidents, a secretary and a treasurer for a term of one year. All elected officers, except the treasurer, shall be elected from the membership of the Board of Directors. The treasurer may or may not be a member of the Board.

The following officers were elected by the Board and serving at December 31, 2002:

<u>Officer</u>	<u>Title</u>
Arthur Abel Holk	Chairman of the Board
Ralph Timothy Russell	President
Samuel Francis Parker	Secretary
Clair Dean Hansen	Treasurer

It was noted that a vice president had not been elected during the examination period. In addition, Article VI of the By-Laws requires the election of an Executive Vice President. Neither of those positions had been filled at the examination date.

It was also noted that Mr. Kevin Russell, son of the Company's President, was the Chief Investment Officer. Corporate minutes do not report his appointment or election, and the examiners found no evidence that an investment report had been presented to the Company during the examination period.

Committees

No committees were elected nor appointed during the examination period.

Management Contract

A management agreement with the former President of the Company (Manager), effective January 30, 1964, and amended on November 21, 1983, to include the Vice President of the Company, was approved by the Board of Directors. This agreement provided that the Company pay the Manager a salary equal to three percent of all premiums collected, less refunds, and an annual bonus of five percent of the Company's net income computed before the deduction of the bonus and before any

federal and state taxes due.

In return for the aforementioned consideration, the Manager agreed to manage, supervise and promote the general interest of the Company to the best of his ability. The contract would remain in force and effect until either the Company or the Manager gave the other party six months notice in writing of termination. The contract could be terminated by the Company in the event that the Manager committed fraud, felony, or at his death.

On June 16, 1997, the Board of Directors appointed the Vice President as President and General Manager of the Company (President), effective January 1, 1998, under the terms of the same contract as the outgoing Manager. No formal agreements or amendments were executed. The minutes of the Board of Directors meeting served as the "Management Contract."

During the course of the previous examination, the examiners raised the issue of whether the President's *Management Contract* violated ALA. CODE § 27-27-26(a) (1975). On July 19, 2000, an administrative hearing was held by the ALDOI regarding this matter. On September 20, 2000, the Acting Commissioner of Insurance issued an *Order*, which stipulated, in pertinent part, the following:

"...it is hereby ORDERED the examination report of Baldwin Mutual Insurance Company, Inc...be amended to reflect the Commissioner's decision to allow Mr. Russell's compensation agreement to remain in place until such time as it shall be substantially changed or modified. Furthermore, this decision applies solely to the employment contract of Mr. R. Timothy Russell and does not apply to any other individual so employed at the companies nor does it apply to any officer or director of Baldwin Mutual or any other Alabama domestic insurer."

A review of salary, wages, commissions and bonuses determined that the former President and current director received commissions and bonuses (based on fifteen and five percent, respectively, of paid premiums) during the current examination period. The Company provided no evidence of approval of this arrangement from the ALDOI Commissioner. ALA. CODE § 27-27-26(a) (1975), states, in pertinent part:

"Any officer, or director, or member of any committee or any employee...shall not take or receive to his own use any fee, brokerage, commission, gift or other consideration for, or on account of, any such transaction made by, or on behalf of, such insurer."

Based on testimony provided during the aforementioned hearing, it is the examiners' understanding that the *Management Contract* with the former President was assumed by Mr.

Russell when Mr. Russell became President in 1998. The above mentioned *Order* does not extend the terms of the *Management Contract* to include payment of commissions or bonuses based on a percentage of paid premiums to any individual; hence, the Company should cease paying these remunerations to the current President and the former President, and comply with the aforementioned statute and Commissioner's *Order*. A more detailed discussion on this matter may be found in the MARKET CONDUCT ACTIVITIES section of this examination report under the "Producer Licensing" caption.

Conflict Of Interest

The Company follows an established procedure for the disclosure of conflicts between the Company's interests and any personal interests of directors and officers. The annual signed statements of officers and directors for the five-year examination period were reviewed. One conflict was reported by the Chairman of the Board. No other conflicts were disclosed.

As was previously noted, the Company's Chief Investment Officer is the son of the President. In addition, his brother is employed by the Sterne Agee & Leach brokerage firm, through which the Chief Investment Officer conducts many of the Company's investment transactions. The relationship amongst these persons meets the "related person" criteria as defined in Section 10-2B-8.60 of the *Alabama business corporation act*. Item (1) of said section delineates "conflicting interest." The relationships were not disclosed by the President in accordance with item (4) of said section.

It was also noted that the Company executed its custodial agreement with The Trust Company of Sterne Agee & Leach, Inc.

CORPORATE RECORDS

The Certificate of Incorporation and By-Laws, as amended, were inspected during the course of the examination and appeared to provide for operation of the Company in accordance with usual corporate practice and applicable statutes and regulations.

Minutes of meetings of the policyholders and Board of Directors were reviewed for the period under examination. Other than those items previously noted in the MANAGEMENT AND CONTROL section, the minutes appeared to be complete with regard to recording actions taken on matters before the respective bodies for deliberation and action.

HOLDING COMPANY AND AFFILIATE MATTERS

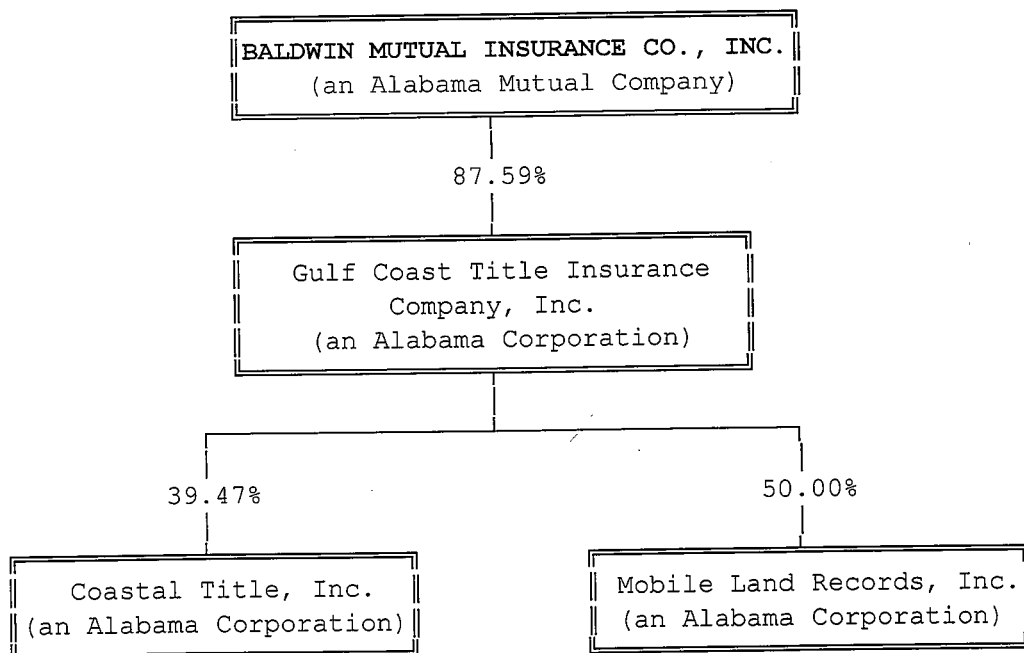
Holding Company Registration

The Company is deemed to be subject to the *Alabama Insurance Holding Company Regulatory Act*, as defined in ALA. CODE § 27-29-1 (1975). In connection therewith, the Company and its subsidiary, GCTIC, are registered with the ALDOI as joint registrants of an Insurance Holding Company System.

The original Form B *Annual Registration Statement* was filed in 1979, and amendments have been filed by the Company on an annual basis. Appropriate filings required under the Holding Company Act were made from time to time by the Company as joint registrant. A review of the Company's filings for the five-year period under examination indicated that all required disclosures were included, with the exception of those items discussed later in this section under the caption "Transactions and Agreements with Affiliates."

Organizational Chart

The following chart presents the identities of and interrelationships among all affiliated persons within the Insurance Holding Company System at December 31, 2002:



Transactions and Agreements with Affiliates

The examination as of December 31, 1997, noted that several cost sharing, management, service or rental arrangements, for which no written agreements existed, were in effect during the period of that examination. Certain unwritten arrangements with the subsidiary and/or affiliated companies included but were not limited to, the following:

- storage and rental transactions;
- federal income tax allocation;
- administrative and accounting services; and
- the leasing of certain computer data processing equipment.

During the current examination period, the Company reduced its arrangements to writing and submitted the agreements to the ALDOI for approval by the Commissioner in accordance with ALA. CODE § 27-29-5(b) (1975), which states:

“...transactions involving a domestic insurer and any person in it holding company system may not be entered into unless the insurer has notified the commissioner in writing of its intention to enter into such transaction at least 30 days prior thereto, or such shorter period as the commissioner may permit, and the commissioner has not disapproved it within that period.”

The Company's files and those of the ALDOI did not contain evidence that the agreements had been approved. Company management indicated that, in accordance with the aforementioned section of the *Alabama Insurance Code*, the agreements were deemed approved after 30 days of submission to the Commissioner.

Unless otherwise stated, the following summarized agreements were in effect at December 31, 2002:

A. Lease Agreements:

(1) At the examination date, the Company had a written agreement with GCTIC, its subsidiary, to rent 449 square feet in the home office building located at 315 E. Laurel Avenue, Foley, Alabama. GCTIC agreed to pay the Company \$3,592 annual rent, payable at \$299.33, “on or before the first day of each month thereafter, during the continuance of this lease.”

The lease stipulated that the Company had the “option to renew for an additional one year period on the same terms and conditions” provided that sixty days notice was given “in advance of the expiration of the initial term hereof of its intention to so renew.”

(2) Handwritten journal entries indicated that the Company paid the affiliated Mobile Land Records \$305 per month for rent, and 20 per cent of their utility bill. Mobile Land Records paid the Company \$30 per month for storage. There were no written contracts.

B. Electronic Data Processing (EDP) Equipment Arrangements:

GCTIC owned the EDP system and equipment used by the Company in accordance with "a cost sharing arrangement." In 2002, the Company paid GCTIC more than ninety thousand dollars in computer and microfilm fees. Concerning these arrangements, the Company provided two single page statements, both dated January 2, 2001, disclosing the following information:

- (1) "Gulf Coast Title Insurance Company provides microfilming services for Baldwin Mutual Insurance Company at the rate of \$500.00 per month."
- (2) "The following services are provided by Gulf Coast Title Insurance Company for Baldwin Mutual Insurance Company: Computer Processing, Management, Software, Hardware, Maintenance and use of Mobile and Baldwin County land records, at the rate of \$7,120.39 per month."

C. Tax Allocation Agreement:

NOTE 9, item D of the Annual Statement's *Notes to Financial Statements* reported that a consolidated income tax return was filed with GCTIC. The following information was disclosed in the Form B filings under Item 5(h):

"A consolidated income tax return is filed with the Company's majority-owned subsidiary, Gulf Coast Title Insurance Company, Incorporated. The method of allocation between the companies is subject to a written agreement approved by the Board of Directors. Allocation is based upon separate return calculations with current credit for net losses. Intercompany tax balances are settled annually in the first quarter."

A Board of Directors resolution, dated February 23, 1989, specified "that the total tax liability of the group is allocated on a pro-rata basis, based on the taxable income of each company in relation to the total taxable income of the group." Management provided a one page *Tax Agreement*, which was not dated, stating the following:

"Pursuant to Board of Director's resolution, the above referenced companies agree to the following tax allocation:

The Fedral [sic] income tax liability of Gulf Coast Title Insurance Company, Incorporated is to be calculated on the basis of a stand alone company. Baldwin Mutual Insurance Company's income tax liability is calculated at the maximum marginal rate in effect for the consolidated companies, with Gulf Coast Title Insurance

Company, Incorporated receiving the benefit of the tax brackets.”

D. Accounting, Operating and Service Arrangements:

Various accounting functions, including the formulation of financial statements and reports, and the convention blanks, were prepared by a CPA. Several accounting and bookkeeping services were performed by Company employees for its subsidiary, GCTIC. No written agreements were provided that detailed specific performances, tasks, fees or remuneration.

As was noted in the previous examination, the examiners were unable to determine that the benefits to the Company derived from the various operating, management and service agreements were fair and reasonable in accordance with ALA. CODE § 27-29-5(a)(1) (1975). The Company had still not performed any analysis to determine that the services being provided (which included but were not limited to accounting, administrative and data processing services) were fair and reasonable in comparison to what a comparable outside service would cost.

Item (4) of the aforementioned section of the *Alabama Insurance Code* states that:

“The books, accounts and records of each party will be so maintained as to clearly and accurately disclose the precise nature and details of the transactions.”

ALA. CODE § 27-29-5(b) (1975) states, in pertinent part, that:

“...transactions involving a domestic insurer and any person in its holding company system may not be entered into unless the insurer has notified the commissioner in writing of its intention to enter into such a transaction at least 30 days prior thereto...and the commissioner has not disapproved it...”

In addition, ALA. CODE § 27-27-29(a) (1975) requires that the Company maintain “...complete records of its assets, transactions and affairs...”

Because several of the arrangements with affiliated companies were not detailed, the specifics of various transactions could not be determined by this examination. ALA. CODE § 27-29-4(b)(3) (1975), requires that information about the agreements in force between an insurer and its affiliates be made current in the filing of the annual Form B Registration Statement. The agreements discussed in items A, B and C, above, were appropriately disclosed on the 2002 filing.

FIDELITY BOND AND OTHER INSURANCE

At December 31, 2002, the Company was a named insured under a Financial Institution Bond, issued by Traveler's Casualty and Surety Company of America. The single loss limit liability of the bond was \$500,000, with a single loss deductible of \$20,000, which exceeded the minimum requirements for fidelity coverage, as defined by NAIC guidelines.

During the period under examination, the Company maintained the following coverages:

- Professional Liability
- Directors and Officers Liability
- Property Fire and Hazard
- Commercial Automobile
- Executive Life.

The coverages and limits carried by the Company were reviewed during the course of the examination and appeared to adequately protect the Company's interests.

During the review of real estate properties, it was determined that the Company did not have liability coverage on one property. When this matter was brought to the Company's attention, management immediately provided coverage for the property. It was noted that the Company was writing insurance on its own properties. The Company's President stated that:

"Baldwin Mutual strives to insure all property we own. We have been following this practice for over thirty years. This practice was reviewed and approved by at least seven previous insurance department examinations."

In response to inquiries into why the decision to self-insure the rental properties was made, the President stated:

"We do not self-insure our properties. We either obtain coverage with another company or issue our own policies..." and "...there is a difference in self-insurance and company issued policies. We are not covered with reinsurance when we self-insure. Also, we cannot calculate the losses in our loss rationale, and self-insurance is not covered by the Guaranty Fund."

Insuring Company-owned properties is an unusual business practice as it is high risk and exposes the Company to unrecoverable loss. By electing to self-insure, the Company would essentially have no protection in the event of a loss. At minimum,

management should disclose to its reinsurers that the Company is issuing policies on property that it owns.

EMPLOYEES' AND AGENTS' WELFARE

The Company provided the following benefits for its employees during the five-year examination period:

- Group Term Life Insurance
- Accidental Death and Dismemberment Insurance
- Group Health Insurance
- Paid Vacations and Holidays
- Sick Leave.

The employee benefits shown above were in accordance with usual industry practices. The Company did not fund any benefit plans for its agents.

Deferred Compensation Agreement

At December 31, 2002, the Company had a non-qualified deferred compensation agreement in force. Voluntary employment agreements with certain employees provide the employee, or designated beneficiary, with deferred compensation payments during each of the ten years after termination of employment because of retirement, death or disability. This deferred compensation is made in lieu of current salaries and wages. Following is a summary with quotes from the agreement, taken in part, where deemed necessary:

- 1) The Company "agrees to employ and the employee agrees to serve...and continuing until terminated by either party on at least 90 days prior written notice to the other."
- 2) The agreement required the employee to "devote all of his time, attention, skill and efforts to the performance of his duties for the Corporation."
- 3) The Company agreed to pay the employee a salary "as the Board of Directors may from time to time determine together with deferred compensation."
- 4) The Company agreed to credit to a deferred compensation account (account) certain amounts on a quarterly basis.
- 5) The funds of the account "may be kept in cash or invested and

- reinvested in mutual funds, stocks, bonds, securities, or any other assets as may be selected by the Board in its discretion.”
- 6) The agreement stated that the employee agrees to assume all risk to any decrease in the account balance of the account.
 - 7) “Title to and beneficial ownership of any assets, whether cash or investments which the Corporation may earmark to pay the contingent deferred compensation hereunder, shall at all times remain in the Corporation and the Employee and his designated beneficiary shall not have any property interest whatsoever in any specific assets of the Corporation.
 - 8) The benefits are to be paid to the employee after he leaves the Company. The method of payment is to pay the employee a minimum number of annual installments based on the fair market value of the assets in the account and starting on the date he leaves the Company. The annual installments will be adjusted up or down, but not more often than semi-annually, “to reflect the appreciation or depreciation in value” of the account.
 - 9) “Any funds which may be invested under the provisions of this Agreement shall continue for all purposes to be a part of the general funds of the Corporation and no person other than the Corporation shall by virtue of the provisions of this Agreement have any interest in such funds. To the extent that any person acquires a right to receive payments from the Corporation under this Agreement, such right shall be no greater than the right of any unsecured general creditor of the Corporation.”

The various accounts included such assets as bonds, stocks, mortgage loans, real estate and cash. In reviewing the deferred compensation investments included on the various schedules of the Annual Statement, it was noted that there were no indications on the schedules that these investments had been designated as restricted. The NAIC’s Annual Statement Instructions require that these assets are shown in *General Interrogatory* #19, and each is “to be individually identified in the asset schedules” using the appropriate symbol. In addition, *SSAP No. 14*, section 5, of the NAIC’s Accounting Practices and Procedures Manual requires that “Plan assets...shall be segregated and restricted, and measured at fair value.” The liability for this pension plan was included in the line item captioned *Amounts withheld or retained by company for account of others* on the balance sheet.

NOTE 12 of the Annual Statement’s *Notes to Financial Statements* section requires disclosure of information concerning retirement plans, deferred compensation, postemployment benefits and compensated absences and other postretirement benefit

plans. The Company reported "None." Since Codification, accounting guidance is now provided by *SSAP No. 8*, (Pensions), *SSAP No. 11* (Postemployment Benefits and Compensated Absences), and *SSAP No. 14*, (Postretirement Benefits Other Than Pensions), of the NAIC's Accounting Practices and Procedures Manual.

Section 1033 of Title 18 of the US Code

The Company was asked how it determined if prospective and current employees were in conflict with Section 1033 of Title 18 of the US Code and ALA. ADMIN CODE 482-1-121 (2003), *Procedures Governing Persons Subject To 18 U.S. Code §1033*, which prohibit certain persons from participating in the business of insurance. The President stated that prospective employees are screened through a professional employment agency, which reviews an individual's employment, financial and arrest history for compliance with any federal, state and local laws.

Apparently, current employees are monitored on an on-going basis, utilizing the services of a Mobile labor attorney, who works with the Company to maintain compliance with federal and state laws. However, the Company did not have written documentation available for review evidencing that these employees are not in conflict with Section 1033 of Title 18 of the US Code, and that the employment agency has verified that new employees are not in violation of the same.

SPECIAL DEPOSITS

In order to comply with the statutory requirements of the State of Alabama, the Company had the following security on deposit with the Alabama State Treasurer at December 31, 2002:

<u>Description</u>	<u>Par Value</u>	<u>Market Value</u>	<u>Statement Value</u>
Colonial Bank, Foley, Alabama Certificate of Deposit, 2.15%, (Auto renewal)	<u>\$100,000</u>	<u>\$100,000</u>	<u>\$100,000</u>

Confirmation of this deposit was obtained directly from the ALDOI.

FINANCIAL CONDITION/GROWTH OF THE COMPANY

The following table sets forth the significant items indicating the growth and financial condition of the Company for the period under review:

	<u>ADMITTED ASSETS</u>	<u>LIABILITIES</u>	<u>SURPLUS</u>	<u>PREMIUMS EARNED</u>	<u>LOSSES INCURRED</u>
2002*	\$12,819,708	\$6,250,862	\$6,568,846	\$9,464,395	\$3,989,340
2001	13,744,403	5,733,956	8,010,447	9,036,105	3,859,425
2000	13,272,066	6,079,081	7,192,985	8,818,703	4,222,271
1999	12,276,561	5,728,070	6,548,491	8,844,268	3,872,133
1998	11,079,633	5,320,489	5,759,174	8,859,950	5,590,548
1997*	10,906,722	5,849,589	5,057,133	8,315,565	3,844,604

* Per Examination

MARKET CONDUCT ACTIVITIES

Territory

At the examination date, the Company was licensed to transact business in the State of Alabama with the lines of fire and allied being written. The Certificate of Authority was inspected for the five-year period under review, and no exceptions were noted.

There were no pending applications at December 31, 2002, and Company management indicated that there were no plans at this time for entry into other states.

Plan of Operation

The Company marketed property and casualty insurance in the State of Alabama. Products consisted of farm, home, manufactured housing and commercial policies. The Company operated on a mutual basis issuing only non-assessable policies with the business acquired on a direct writing plan with approximately 250 commissioned agents. The agents are compensated at a 15 percent commission rate. Additional compensation in the form of a bonus was paid based on the loss ratio of business produced not to exceed an additional five percent.

Company Operations/Management

The NAIC Annual Statements for the five-year period of the examination of January 1, 1998 – December 31, 2002, were reviewed to determine if the Company was licensed only in the states in which it was writing business. The Company was licensed in the State of Alabama to write fire and allied lines of insurance for the examination period, per *Schedule T* of the Annual Statements.

Management stated that the Company had central recovery and backup procedures for protecting the integrity of its records. At the examination date, there were no written procedures for the recovery/backup plan, or accompanying procedure manuals, to define the methods for protecting the integrity of its records that are maintained offsite, whether electronic or not, which would be used to start operations anew.

COMPANY OPERATIONS/MANAGEMENT Standard 3 - The Company has antifraud initiatives in place that are reasonably calculated to detect, prosecute, and prevent fraudulent insurance acts.

Antifraud Plan and Implementation

The Company did not have an antifraud plan as recommended by Company Operations/Management Standard 3 of the NAIC's Market Conduct Examiners Handbook.

COMPANY OPERATIONS/MANAGEMENT Standard 7 - Records are adequate, accessible, consistent and orderly, and comply with state record retention requirements (ALDOI Regulation No. 118).

Record Adequacy

The Company's underwriting guidelines require that policy files contain the following documentation relating to the policyholder:

- original application
- calculation of premium
- declaration page
- pictures of the risk
- endorsements, if any
- claims, if any
- complaints, if any.

Fifty files were selected from new business written during the examination period of January 1, 1998 – December 31, 2002, in order to determine that the files contained

all of the essential documentation. Company personnel provided all 50 files requested by the examiners. The review of these policy files determined that certain files did not contain all the relevant information in accordance with Company underwriting guidelines. Ten files did not evidence mandatory physical inspection documentation, and two applications had not been signed. The documentation in these files should be maintained in accordance with Company underwriting guidelines and ALA. CODE § 27-27-29 (1975), which requires an insurer to maintain complete records of its insurance transactions and affairs.

Record Retention

As noted in the *Record Adequacy* section above, a sample of new business written during the five-year examination period was reviewed for accuracy and completeness. Certain information was missing from the files, including physical inspection documentation and signed applications. These files were not complete and documentation had not been retained in accordance with Section 3, of ALDOI *Regulation No. 118*, which states that a company should maintain all records of its insurance transactions for a retention period of "...not less than five (5) years."

COMPANY OPERATIONS/MANAGEMENT Standard 10 - The Company has procedures for the collection, use, and disclosure of information gathered in connection with insurance transactions so as to minimize any improper intrusion into the privacy of applicants and policyholders.

Procedures to Limit Access to Personal Information

The review of the Company's Notice of Privacy Policy form indicated that the Company did not have procedures for the collection, use and disclosure of information to limit access to this personal information as defined by Company Operations/Management Standard 10 of the NAIC's Market Conduct Examiners Handbook. Additional discussion concerning person information may be found later in this section under the "Privacy Policies and Practices" caption.

Complaint Handling

Complaints recorded by the Consumer Division of the ALDOI in the *Company Complaint Report*, were compared with the complaints received by the Company for the period between January 1, 1998, and December 31, 2002. There were two complaints recorded by the ALDOI and submitted to the Company for handling. The Company did not maintain a complaint register or log in accordance with NAIC guidelines.

COMPLAINT HANDLING Standard 1 - All complaints are recorded in the required format on the Company complaint register.

Complaint Log and Documentation

The Company was not maintaining a complaint register as defined by Complaint Handling Standard 1 of the NAIC's Market Conduct Examiners Handbook, and ALA. CODE § 27-27-29(a) (1975), which states that an insurer should maintain complete records of its insurance transactions and affairs.

COMPLAINT HANDLING Standard 2 - The Company has adequate complaint handling procedures in place and communicates such procedures to policyholders.

Complaint Procedures Manual

Although the Company had some procedures in place for the handling of complaints, the procedures were not adequate and did not appear to be easily communicated to policyholders, as defined in Complaint Handling Standard 2 of the NAIC's Market Conduct Examiners Handbook.

COMPLAINT HANDLING Standard 3 - The Company takes adequate steps to finalize and dispose of the complaint in accordance with applicable statutes, rules and regulations, and contract language.

Complaint documentation

A review of policy files for both complaints indicated that the Company was not keeping all of the documentation in the files that evidenced complaints were being fully addressed, as defined by the following regulatory authorities:

- Complaint Handling Standard 3 of the NAIC's Market Conduct Examiners Handbook;
- ALDOI Regulation No. 118, requiring responses to the ALDOI within a 10-day time frame; and
- ALA. CODE § 27-27-29(a) (1975), concerning the maintenance of complete records.

Incomplete documentation included lack of responses from the Company for complaints from consumers, no evidence of finalization and disposition of complaints, and replies to the ALDOI within the required 10-day time frame. Notations on the ALDOI's Company Complaint Report detailed conversations and correspondence with not only the complainant but with specific Company personnel. The Company's files did not evidence similar documentation.

COMPLAINT HANDLING Standard 4 - The time frame within which the Company responds to complaints is in accordance with applicable statutes, rules and regulations.

Response Time

As was noted previously in the *Complaint Documentation* section above, the review of complaints indicated that the Company did not maintain adequate documentation from the ALDOI, or the responses to complaints, which could be utilized to determine the response time, as required by Complaint Handling Standard 4 of the NAIC's Market Conduct Examiners Handbook. ALDOI *Regulation No. 118*, requires an insurer to provide a written response to the ALDOI within 10 working days. The ALDOI's *Company Complaint Report* indicated that the Company did not provide a written response within that time frame for one of the complaints.

Marketing and Sales

The Company currently markets fire and allied lines of insurance in Alabama, the only state in which it is licensed to do business. The Company does not have a formal advertising/marketing program but does limited advertising by newspaper and radio in the Baldwin County area.

Business is written by direct bill in one, two and three year terms. The Company utilizes State Farm Insurance agents exclusively to write business. The Company's President stated that he was not aware of any advertisements prepared by the Company's agents.

Control of Advertising Content, Form and Dissemination

C.2. (*Techniques*) in the Marketing and Sales section of the NAIC's Market Conduct Handbook, requires "...every insurance company...to have procedures in place to establish and at all times maintain a system of control over the content, form and method of dissemination of all of its advertisements." During the review of advertising materials, it was noted that there were no written contracts between the Company and its producers. Since there are no contracts with the agents, the Company could not evidence that it had control over the content, form or method of agent advertising.

<i>MARKETING AND SALES Standard 1 – All advertising sales materials are in compliance with applicable statutes, rules and regulations.</i>

Advertising File

It was also noted that the Company did maintain an advertising file in accordance with Section 20, item B. of ALDOI *Regulation No. 13*, which requires, in pertinent part:

"Each insurer shall maintain at its home or principal office a complete file containing every printed, published or prepared advertisement...with a notation attached to each such advertisement which shall indicate the manner and extent of distribution and the form number of any policy advertised. Such file shall be subject to regular and periodical inspection by this Department...and maintained...for the most recent four year period or until the next regular NAIC examination of the insurer."

A review of the file did not indicate any notations attached to each form of advertising material, as required by the aforementioned regulation.

Advertising Certificate of Compliance

The Company did not file an advertising *Certificate of Compliance* with its Annual Statement in accordance with item C., of the above referenced regulation, which requires:

"...a Certificate executed by an authorized officer of the insurer wherein it is stated that to the best of his knowledge information and belief the advertisements which were disseminated by the insurer during the preceding statement year complied or were made to comply in all respects with the provisions of these regulations and Interpretive Guidelines issued by the Commissioner."

The Company has an Internet web site, www.baldwinmutual.com, which is a homepage only. The site is not used for any marketing of its products.

The producer sales materials and policy forms reviewed by the examiners were approved by the Company's President and met the requirements of Marketing and Sales Standards 2, 3 and 4 of the NAIC's Market Conduct Examiners Handbook.

Producer Licensing

The examiners conducted a review of the Company's list of 300 active producers and the ALDOI's list of 284 active appointments for the appropriate years to determine the Company's adherence to the applicable Alabama statutes and regulations.

PRODUCER LICENSING Standard 1 - Company records of licensed and appointed (if applicable) producers agree with department of insurance records.

PRODUCER LICENSING Standard 2 - The producers are properly licensed and appointed (if required by state law) in the jurisdiction where the application is taken.

Producer licenses and appointments

The Company's list of active producers was reconciled with the ALDOI's list of active appointments to determine any discrepancies with the Company's adherence to

ALA. CODE § 27-7-4(a) (1975), which requires a person selling insurance to be licensed for that line of authority; and ALA. CODE § 27-7-30(a) (1975), which requires each insurer appointing a producer to file a notice of appointment with the Commissioner. The review indicated that there were nine agents that needed to be appointed in accordance with the above mentioned regulatory authorities.

Subsequent to the examination date, the Company has taken corrective action to complete the necessary steps to appoint agents with the ALDOI.

Procedures for appointment

It was noted that the Company did not have written procedures to evidence the Company's methods concerning producer licensure and appointment.

File Documentation

The review of producer files indicated that the Company was not maintaining producer licenses and appointment forms in the files. ALA. CODE § 27-27-29(a) (1975) requires the Company to maintain complete records of all its transactions and affairs.

Business Produced by Officers and/or Directors Not Appointed by the Company as Agents

In order to determine that the Company was accepting business from only licensed and appointed agents, the examiners chose a random sample of 50 items from new business written during 2002. A review of the selected producers indicated that one agent was not appointed by the Company. ALA. CODE § 27-7-4(a) (1975) states that:

“Any insurer accepting business directly from a person not licensed for that line of authority **and not appointed** [emphasis added] by the insurer shall be liable to a fine up to three times the premium received from that person.”

Item (b) of said section stipulates that “No producer shall act on behalf of any insurer for which an appointment is not held...” The agent was the President (and a director) of the Company, and premiums received from him during the five-year examination period totaled \$1,676,674. During that time, the President was paid \$289,898 in commissions and bonuses for business produced, which was in addition to amounts paid under his compensation agreement. (Also see additional information under the “Management Contract” caption in the MANAGEMENT AND CONTROL section, elsewhere in this report.)

Because the agent was an officer and director of the Company, the examiners reviewed payments made to all Company management personnel to insure proper

licensure and appointment. This review indicated that another director was not appointed in 1998, 1999, 2001, and 2002; said agent generated a total of \$1,687,946 in premiums during those years of the examination period. This director was paid \$347,046 in commissions and bonuses for that business produced. The total premiums received from these two producers totaled \$3,364,620 [\$1,676,674 + \$1,687,946]. Consequently, the Company is contingently liable for a fine of up to three times the premium received, or \$10,093,860 [\$3,364,620 x 3] in accordance with the aforementioned section of the *Alabama Insurance Code*.

Each insurer appointing producers must file a notice of appointment with the Commissioner in accordance with ALA. CODE § 27-7-30 (1975). In response to the examiners' request to inspect the notice of appointment documentation, the President stated:

"Your code reference (27-7-30) does not apply to our situation. I am an employee and an officer of the Company. My arrangement was approved by Commissioner DeBellis. It has been confirmed by seven previous department examinations. Numerous contacts have been made with officials of the Department over the past 31 years which authorized and confirmed our arrangement."

Notwithstanding the compensation agreement, ALA. CODE § 27-7-4(a) (1975) requires that agents be both licensed and appointed in order to produce business for an insurer. ALA. CODE § 27-7-4.2(1) defines exceptions to licensing requirements "provided that the officer, director, or employee does not receive commission on policies written or sold..." The President received commissions during the five-year examination period, and consequently, was not eligible for exemption from licensure. Further discussion on this matter may be found under *Commission Payments to Officers or Directors*, following this section.

Commission Payments to Officers or Directors

As a result of previous examination findings, a Commissioner's *Order*, dated September 20, 2000, reflected "the Commissioner's decision to allow Mr. Russell's compensation agreement to remain in place until such time as it be substantially changed or modified. Furthermore, this decision applies solely to the employment contract of (the current President) and does not apply to any other individual so employed at the companies nor does it apply to any officer or director of Baldwin Mutual or any other Alabama domestic insurer."

The President's compensation agreement states:

"The COMPANY agrees to pay the MANAGER a salary equal to three percent (3%) of all premiums collected and in addition to an annual bonus of 10% of the

COMPANY'S net income computed before the deduction of the bonus and before any Federal and State taxes due."

The computation of the President's salary in accordance with the *Management Contract* allowed by the Commissioner's *Order* was verified to the General Ledger, reported on the Annual Statement, and disclosed on Federal Form W-2. The *Management Contract* does not provide for additional commission based on business produced as an agent. A separate Form-1099 was issued to the President, which accounted for \$289,898 in commissions (15 percent of paid premium) and bonuses (five percent of paid premium, paid one year in arrears) for the five-year examination period, based on his insurance business writings. This amount was in addition to the aforementioned salary under the *Management Contract*. Furthermore, another director was paid commissions and bonuses totaling \$432,043 for the same period. Remuneration to the President (\$289,898), and to that director (\$432,043) totaled \$721,941. ALA. CODE § 27-27-26 (1975) states that:

"Any officer, or director...shall not take or receive to his own use any fee, brokerage, commission, gift or other consideration, for, or on account of, any such transaction made by, or on behalf of, such insurer."

Commission Payments to Officers and/or Directors not Licensed and Appointed

As noted in two of the above mentioned captions [*Business Produced by Officers and/or Directors Not Appointed by the Company*, and *Commission Payments to Officers or Directors*], commissions were paid to officers/directors, who were not appointed in accordance with ALA. CODE § 27-7-4(a) (1975). Although the individuals were licensed, the President was not appointed from 1998 - 2002, and the director was not appointed in 1998, 1999, 2001 and 2002. Commissions totaling \$636,944 [\$289,898 + \$347,046] were paid to these persons during those years in which they were not appointed. ALA. CODE § 27-7-4.1(b) (1975) states that:

"Any insurer or producer violating this section shall be liable for a fine in an amount of up to three times the amount of the commission paid. The fine shall be levied and collected by the commissioner."

Consequently, the Company would be contingently liable for a fine of up to three times \$636,944, or \$1,910,832, in accordance with the above mentioned section of the *Alabama Insurance Code*.

Underwriting and Rating

Rating Practices

The Company has two rating organization affiliations, the Insurance Services Office (ISO) for its dwelling program, and the American Association of Insurance Services (AAIS) for farm and country programs. The Company has an independent filing program for its mobile home business. There is no electronic rating/quote program, but the Company is in the process of developing one. No new rate or form filings were made during the five-year examination period of January 1, 1998, through December 31, 2002.

Underwriting Practices

The Company was authorized to engage in the writing of multiple lines, providing homeowners, farmowners, miscellaneous property lines, personal liability and commercial lines insurance products. Standard policy forms and endorsements, promulgated by ISO and AAIS, and prescribed and approved by the ALDOI, were utilized. All changes in protection class are furnished to the Company by ISO. These are reviewed and entered into the Company's automated system and then distributed to all employees involved in underwriting and rating. The agents are provided with an Agent's Manual containing all of the Company's Underwriting Guidelines. All policies and endorsements originated in the Home Office.

Termination Practices

The Company handles all cancellation requests in writing. If a policy is cancelled at the Company's request, the earned premium is computed on a pro-rata basis. If it is the insured's request, the earned premium is computed according to standard short rate tables.

There are no specific state laws governing the reasons for cancellation of property insurance. All of the policy cancellations selected for review had valid reasons, per the Company's policy provisions, for cancellation of the policies.

All declinations are handled by the underwriting department, and written notification is given to the applicants, mortgagees, lienholders and agents.

<i>UNDERWRITING & RATING Standard 15: Underwriting Practices - File documentation adequately supports decisions made.</i>
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File Documentation

A sample of the 50 policy files was reviewed for completeness and signature by the agent; 48 files were complete and signed by the agents. Two of the files were

completed, but not signed by the agent. The Company should maintain complete records of its underwriting transactions in accordance with ALA. CODE § 27-27-29 (1975), which requires that a company maintain all records of its insurance transactions and affairs.

In reviewing the files for determination of exposure, it was found that 10 of the files did not document whether an inspection had been made, and one file indicated that an inspection had not been made. This is in direct violation of the Company's underwriting guidelines under the "Agents Inspection" section of the Agents Manual, which states that the Company requires physical inspection to confirm and recommend the exposure. In addition, Underwriting & Rating Standard 15, of the NAIC's Market Conduct Examiners Handbook stipulates that file documentation should be maintained in order to adequately support decisions made.

Premium refunds

It was noted that policy provisions in the Company's agent's manual state the following:

"...Company's request, the earned premium shall be computed on a pro rata basis. Insured's request, the earned premium shall be computed according to standard short rate tables. The minimum premium retained will be \$25.00."

There is no provision in ALA. CODE § 27-36-3 (1975) [*Unearned premium reserves: property, casualty, and surety insurance*] that permits the Company to retain a minimum of \$25 of the premium.

Claims

Claims Payment Practices

At December 31, 2002, there were no Alabama statutes, regulations or bulletins concerning standards for the investigation and settlement of claims. ALA. ADMIN. CODE 482-1-125 (2003), which had not been passed at the examination date, was used as a guideline in the review of claims for the purposes of this examination. This regulation, effective May 21, 2003, sets forth minimum standards for the investigation and disposition of property and casualty claims. Section .04, captioned "File and Record Documentation," defines the maintenance of claims files so that data is accessible and retrievable for examination purposes. The administrative code also states that "an insurer shall be able to provide the claim number, line of coverage, date of loss, and date and amount of payment."

A time study was performed on a sample of cancelled checks for claims payments. The

average number of days between the date that a check was issued and the date the check was cleared was 17 days. The claim checks appeared to be promptly mailed or delivered within a reasonable time frame. None were deemed excessive.

CLAIMS Standard 11 – Denied and closed-without-payment claims are handled in accordance with policy provisions and state law.

Denied and closed-without-payment claims

The Company's claims department was unable to provide a list of denied and closed-without-payment claims. A Company official stated that an attempt to produce such a list would be "extremely time consuming and burdensome." The Claims Manager indicated that the Company would consider such a listing in the future upon consultation with and direction from legal counsel. The examiners were unable to determine if any denied or closed-without-payment claims were based on policy provisions, state statutes and regulations and whether any denial notices had been sent to policyholders or claimants.

ALDOI *Regulation No. 118*, Section 3, requires an insurer to maintain records required for the purposes of statutory examination. Because the Company had not maintained a listing of closed-without-payment claims, the examiners were unable to determine a basis for denial of claims. In addition, Section (a) of ALA. ADMIN. CODE 482-1-125-.04 (2003), requires that an "insurer shall maintain claim files that are accessible and retrievable for examination..." and specifically includes "information...for all claims closed without payment." Further, "[t]he data must be available for all open and closed files for the current year and the five (5) preceding years, in order to permit reconstruction of the insurer's activities relative to each claim."

Notices of Claim Denials to Policyholders

Without a list of denied and closed-without-payment claims, the examiners were unable to determine if notices of claim denials referenced policy provisions or a reasonable basis for denial of a claim. In addition to the aforementioned regulation section, ALDOI *Regulation No. 118*, Section 3, requires an insurer to maintain proper records in order to make a determination on the financial condition of the Company.

Privacy Policies and Practices

[Compliance with ALA. ADMIN. CODE 482-1-122 (2002), formerly known as ALDOI *Regulation No. 122*.]

The Company's Notice of Privacy Policy, Form 121, which was first sent as a mass mailing to all Company policyholders on May 30, 2001, was reviewed for compliance to ALA. ADMIN. CODE 482-1-122 (2002). The Company sends the notice to new

business policyholders, when a policy is rewritten or renewed, and annually thereafter.

The privacy form contained *Our Privacy Principles*, which emphasized and explained the Company's policies. These principles appeared to follow the guidelines established in ALA. ADMIN. CODE 482-1-122-.07 (2002), *Information to be included in privacy notices*.

COMPANY OPERATIONS/MANAGEMENT Standard 10 - The company has procedures for the collection, use, and disclosure of information gathered in connection with insurance transactions so as to minimize any improper intrusion into the privacy of applicants and policyholders.

Procedures to Limit Access to Personal Information

During the review of the Company's Notice of Privacy Policy form, it was noted that the Company did not have procedures for the collection, use and disclosure of information to limit access to this personal information as defined by Company Operations/Management Standard 10 of the NAIC's Market Conduct Examiners Handbook. Without specific procedures, the Company could not evidence that improper intrusion into the privacy of its applicants and policyholders was minimized.

The Company does inform the consumers of what information is shared, why it is shared and with whom it is shared.

Opt Out Method for Disclosure of Nonpublic Personal Financial Information

The review of the privacy policy form provided by the Company indicated that the Company had not provided a reasonable means to opt out of disclosure of nonpublic personal financial information. ALA. ADMIN. CODE 482-1-122-.08, A.(2)(b)(iv) (2003), *Form of opt out to consumers and opt out methods*, states that the licensee provides a reasonable means to exercise an opt out, if it does any of the following:

- “(i) Designates check-off boxes in a prominent position on the relevant forms with the opt out notice.
- (ii) Includes a reply form together with the opt out notice.
- (iii) Provides an electronic means to opt out, such as a form that can be sent via electronic mail or a process at the licensee's web site, if the consumer agrees to the electronic delivery of information.
- (iv) Provides a toll-free telephone number that consumers may call to opt out.”

The Company listed a telephone number on the Notice of Privacy Policy that consumers may call to request that information not be shared; however, the number was not toll-free, as required in item (iv) of the above mentioned regulation code. The burden of the call would be on the consumer.

The Company did not have any joint marketing that would require the sharing of nonpublic personal financial information. *Our Privacy Principles* in the Notice of Privacy Policy, stated that the Company does not disclose consumer information to any nonaffiliated third party.

The Company does not disclose nonpublic personal health or medical information.

REINSURANCE

Reinsurance Assumed

The Company did not assume any business as reinsurance during the five-year examination period, and no contracts for assumed reinsurance were in effect at December 31, 2002.

Reinsurance Ceded

At December 31, 2002, the Company's ceded reinsurance program consisted of the following treaties:

- (1) Excess of Loss Reinsurance
 - Exhibit A – Property business
 - Exhibit B – Liability business
- (2) Excess Catastrophe Reinsurance
 - Property business

(1) Excess of Loss Reinsurance

The *Excess of Loss Reinsurance* contract between the Company and General Reinsurance Corporation, Stamford, Connecticut, was effective January 1, 2002, and will continue until terminated. The reinsurer will indemnify the Company for all losses and loss adjustment expenses (LAE) in accordance with the terms of the contract as specified in *Exhibit A* and *Exhibit B*, discussed below.

- ***Exhibit A – Property Business***

Exhibit A – Property business applies to all business classified as fire, earthquake allied lines, homeowners multiple peril (property coverages) or farmowners multiple peril (property coverages), except those lines specifically excluded by the contract. The reinsurer will indemnify the Company for losses in excess of the Company's retention, but not greater than the limit of the liability in respect to per risk and all risk involved

in one occurrence as listed below:

DESCRIPTION	AMOUNT
Company's Retention	\$ 60,000
Reinsurer's limit per risk	190,000
Reinsurer's limit (one occurrence)	450,000

The maximum risk on an individual policy insured under the contract was \$250,000 (\$190,000 in excess of Company's retention of \$60,000). The contract permits the Company to purchase facultative excess of loss or facultative share reinsurance on individual risks that exceed \$250,000. The contract also permits the Company to purchase facultative excess of loss or facultative share reinsurance within the liability of the reinsurer, if, in the underwriting judgment of the Company, the reinsurer will be benefited from the policy.

• ***Exhibit B – Liability Business***

Exhibit B - Liability business applies to all business classified as general liability and comprehensive personal liability, and described in the manuals issued by either the Insurance Services Office (ISO) or the American Association of Insurance Services (AAIS).

DESCRIPTION	AMOUNT
Company's Retention	\$ 30,000
Reinsurer's limit per risk	270,000

The maximum risk with respect to individual policies under the contract were:

- (a) General Liability limit of \$300,000
- (b) Comprehensive Personal Liability limit of \$300,000.

The contract permits the Company to purchase facultative excess of loss reinsurance or facultative share reinsurance within the liability of the reinsurer, if, in the underwriting judgment of the Company, the reinsurer will be benefited.

(2) ***Excess Catastrophe Reinsurance***

An *Excess Catastrophe Reinsurance* contract between the Company and Guy Carpenter & Company, Inc., of Pennsylvania, Philadelphia, Pennsylvania, as intermediary, was effective January 1, 2002. The contract provides catastrophe coverage of \$7,750,000, in excess of Company's retention of \$1,000,000, per catastrophe loss, for business

classified as property and occurring during the term of the contract.

ACCOUNTS AND RECORDS

Accounting System

The Company's principal accounting records were maintained primarily on electronic data processing (EDP) equipment. Certain detail and subsidiary records were kept manually.

The Company was audited annually by the certified public accounting (CPA) firm of Taylor, Leaser & Elder, P.C. (formerly known as S.F. Parker and Company, P.C.), Foley, Alabama, which conducted all of the Company's audits for the five-year period covered by this examination. CPA workpapers were made available for review and were tested and utilized in this examination to the extent deemed appropriate. The reports generated by the CPA were reviewed for the examination period.

The Company has utilized this CPA firm for the past twenty years. It was noted that the CPA firm has utilized the same engagement partner since at least 1999. The NAIC's Annual Statement Instructions and Section 7, of ALDOI *Regulation No. 100*, stipulate that:

"No partner or other person responsible for rendering a report may act in that capacity for more than seven (7) consecutive years. Following any period of service such person shall be disqualified from acting in that or a similar capacity for the same company or its insurance subsidiaries or affiliates for a period of two (2) years."

In accordance with said regulation, the Company requested and received relief from the rotation requirement from the ALDOI for the 1997 audit. The Company provided no documentation to evidence that any applications to the Commissioner for relief from the above mentioned rotation requirement had been made since that time.

The NAIC's Annual Statement Instructions also require that the annual audit shall be conducted by an independent CPA in good standing with the American Institute of Certified Public Accountants (AICPA). The AICPA specifies certain standards for independence, including, among others, that management accepts and understands all work performed and all accounting procedures accomplished by the CPA. The CPAs supervised the accounting operations, prepared monthly financial statements, and was primarily responsible for the preparation of the Company's Quarterly and Annual Statements. The Company had no internal audit staff; however, the annual financial

audit was performed by the CPA firm on its own work. Furthermore, Company management described the CPA firm as a party monitoring changes to its Information Systems applications. Independence has not been demonstrated for the purposes of this examination.

It was also noted that Article VII, of the Company's By-Laws states that:

"1. The Board of Directors shall cause to be made annually an audit of the company records at the close of the business day on December 31 by a certified public accountant(s).

A. The same individual or firm shall not be employed for any two successive years."

By retaining the same CPA firm for twenty years, the Company was in violation of its own By-Laws.

The reserve calculations for the examination period were certified by the Company's actuarial consultant, Mr. Matthew P. Merlino, FCAS, MAAA, with Merlinos & Associates, Inc., Norcross, Georgia.

Accounting Practices and Changes

The ALDOI recognizes only statutory accounting practices permitted by the State of Alabama for determining and reporting the financial condition and results of operations of an insurance company, thereby determining its solvency under the *Alabama Insurance Code*. When submitting financial reports to the ALDOI, all insurers are required to use the NAIC Annual Statement Convention Blank prepared in accordance with instructions thereto. Accounting practices and procedures prescribed by the NAIC's Accounting Practices and Procedures Manual are followed except when in conflict with Alabama statutes or other ALDOI rules, regulations or guidelines.

Effective January 1, 2001, the State of Alabama required that Alabama-domiciled insurance companies prepare their statutory basis financial statements in accordance with the Statements of Statutory Accounting Principles (SSAP) of the NAIC's Accounting Practices and Procedures Manual, subject to any deviations advocated or permitted by the Insurance Commissioner of the ALDOI (Codification). The purpose of the codification of statutory accounting principles is to produce a consistent, comprehensive, and comparable basis of accounting and reporting for use by insurance departments, insurers and auditors.

Accounting Records

It was noted that, during the five-year examination period, the Company did not maintain complete electronic data backups as of year-end. Many of the samples utilized during the examination could have been selected electronically with the examiners' audit software had the information been maintained in electronically compatible format. Consequently, numerous samples had to be selected manually thereby delaying the completion of the examination.

Section 3, of ALDOI *Regulation No. 118*, requires that:

“Every insurer... shall maintain its books, records, documents and other business records in order that the insurer's financial condition may be readily ascertained by the Department of Insurance, taking into consideration other record retention requirements. All records must be maintained for not less than five (5) years.”

Section 4, of said regulation stipulates that “records in a computer-based format shall be archival in nature only, so as to preclude the possibility of alteration of the contents of the record by computer after the initial transfer of the record to this format...”

Because the Company maintains the majority of its information in electronic format, backup files should be maintained in order to readily reproduce said records for examination purposes. When this matter was brought to the Company's attention, management indicated that henceforth, electronic backups would be created, as of the Annual Statement date, and stored for the prescribed periods in accordance with the particular regulatory authorities.

Detailed discussions and additional commentary on these matters may be found in the NOTES TO FINANCIAL STATEMENTS and COMMENTS AND RECOMMENDATIONS sections of this examination report, under the captions to which they pertain.

In general, the accounting records appeared to reflect the operations during the period under review and the condition of the Company at December 31, 2002.

FINANCIAL STATEMENTS INDEX

The Financial Statements included in this report were prepared on the basis of the Company's records, and the valuations and determinations made during the examination for the year 2002. Amounts shown in the comparative statements for the years 1998, 1999, 2000, and 2001, were compiled from Company copies of filed Annual Statements. The statements are presented in the following order:

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Statement of Assets, Liabilities, Surplus and Other Funds	35
Statement of Income	37
Capital and Surplus Account	38

**FAILURE OF FINANCIAL STATEMENTS TO BALANCE TO INDICATED TOTALS
IS DUE TO ROUNDING.**

**THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART
THEREOF.**

BALDWIN MUTUAL INSURANCE COMPANY, INC.
STATEMENT OF ASSETS, LIABILITIES, SURPLUS AND OTHER FUNDS
For the Year Ended December 31, 2002

	<u>Current Year Assets</u>	<u>CY Non- admitted Assets</u>	<u>CY Net Admitted Assets</u>	<u>PY Net Admitted Assets</u>
<u>ASSETS</u>				
Bonds (Note 1)	\$ 46,901	\$ 0	\$ 46,901	\$ 66,761
Preferred stocks (Note 2)	222,299		222,299	328,225
Common stocks (Note 3)	2,769,999	10,368	2,759,631	2,907,079
Mortgage loans on real estate – First liens (Note 4)	180,024		180,024	183,877
Real estate: (Note 5)				
Properties occupied by the company	3,078,720	775,720	2,303,000	2,831,527
Properties held for the production of income	235,187	83,874	151,313	222,327
Cash and short-term investments (Note 6)	<u>7,114,754</u>	<u>183,267</u>	<u>6,931,487</u>	<u>6,509,482</u>
Subtotals, cash and invested assets	\$13,647,884	\$1,052,229	\$12,594,655	\$13,049,278
Agents' balances or uncollected premiums: (Note 7)				
Premiums and agents' balances in course of collection	436,245	436,245	0	459,546
Premiums, agents' balances and installments booked but not yet due				
Federal and foreign income tax recoverable (Note 8)				
Guaranty funds receivable or on deposit	71,400		71,400	89,250
Interest, dividends and real estate income due and				
Accrued	7,264		7,264	11,641
Other assets nonadmitted	108,898	108,898	0	
Aggregate write-ins for other than invested assets*: (Note 9)	<u>289,353</u>	<u>142,964</u>	<u>146,389</u>	<u>134,688</u>
TOTALS	<u>\$14,561,044</u>	<u>\$1,741,336</u>	<u>\$12,819,708</u>	<u>\$13,744,403</u>
*Details of write-ins for other than invested assets:				
CSV LIFE INSURANCE (Note 9)	\$ 145,474	\$	\$ 145,474	\$ 131,427
OTHER RECEIVABLES (Note 9)	38,473	37,558	915	3,261
MEMBERSHIPS (Note 9)	0	0	0	
INVENTORY LOSS MITIGATION (Note 9)	0	0	0	0
RIVIERA REFURBISHING LLP	<u>105,406</u>	<u>105,406</u>	<u>0</u>	<u>0</u>
	<u>\$ 289,353</u>	<u>\$ 142,964</u>	<u>\$ 146,389</u>	<u>\$ 134,688</u>

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART
THEREOF.

BALDWIN MUTUAL INSURANCE COMPANY, INC.
STATEMENT OF ASSETS, LIABILITIES, SURPLUS AND OTHER FUNDS
For the Year Ended December 31, 2002

<u>LIABILITIES</u>	<u>Current Year</u>	<u>Prior Year</u>
Losses (Note 10)	\$ 406,199	\$ 211,740
Loss adjustment expenses (Note 10)	116,801	6,443
Commissions payable, contingent commissions and other similar charges (Note 11)	256,393	224,829
Other expenses (excluding taxes, licenses and fees) (Note 12)	465,992	465,207
Taxes, licenses and fees (excluding federal and foreign income taxes) (Note 13)	7,974	6,560
Federal and foreign income taxes (excluding deferred taxes)	315,004	333,044
Unearned premiums (Note 14)	3,511,497	3,343,690
Advance premium (Note 15)	68,519	
Ceded reinsurance premiums payable (net of ceding commissions)	<u>1,102,483</u>	<u>1,142,443</u>
Amounts withheld or retained by company for account of others		
TOTAL LIABILITIES	\$ 6,250,862	\$ 5,773,956
 <u>CAPITAL AND SURPLUS</u>		
Unassigned funds (surplus) (Note 16)	\$ <u>6,568,846</u>	\$ <u>8,010,447</u>
Surplus as regards policyholders	\$ <u>6,568,846</u>	\$ <u>8,010,447</u>
TOTAL LIABILITES, CAPITAL AND SURPLUS	<u>\$12,819,708</u>	<u>\$13,744,403</u>

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART
THEREOF.

BALDWIN MUTUAL INSURANCE COMPANY, INC.
STATEMENT OF INCOME
For the Years Ended December 31, 2002, 2001, 2000, 1999, and 1998

	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>
<u>Underwriting income</u>					
Premiums earned	\$8,783,677	\$8,461,364	\$8,220,412	\$8,264,924	\$8,206,148
<u>Deductions:</u>					
Losses incurred	\$3,797,643	\$3,803,058	\$4,102,884	\$3,633,274	\$4,984,852
Loss expenses incurred	257,646	220,605	85,860	92,026	138,658
Other underwriting expenses incurred	4,401,821	3,949,729	3,772,608	3,821,159	3,654,174
Aggregate write-ins for underwriting deductions:					
Riviera Refurbishing LLP – Equity Loss	9,744	0	0	0	0
Total underwriting deductions	\$8,466,854	\$7,973,392	\$7,961,352	\$7,546,459	\$8,777,684
Net underwriting gain (loss)	\$ 316,823	\$ 487,972	\$ 259,060	\$ 718,465	\$ (571,536)
<u>Investment income</u>					
Net investment income earned	\$ 284,872	\$ 395,450	\$ 507,548	\$ 413,236	\$ 424,934
Net realized capital gains or (losses)	(23,933)	40,640	54,196	81,316	10,860
Net investment gain or (loss)	\$ 260,939	\$ 436,090	\$ 561,744	\$ 494,552	\$ 435,794
<u>Other income</u>					
Aggregate write-ins for miscellaneous income:					
Other income	43,716	45,021	35,711	44,500	56,724
Gain on sale of non admitted assets	0	11,191	5,399	16,400	7,500
Total other income	\$ 43,716	\$ 56,212	\$ 41,110	\$ 60,900	\$ 64,224
Net income before federal and foreign income taxes	\$ 621,478	\$ 980,274	\$ 861,914	\$1,273,917	\$ (71,518)
Federal and foreign income taxes incurred	315,004	333,044	331,207	429,932	(10,815)
NET INCOME	\$ 306,474	\$ 647,230	\$ 530,707	\$ 843,985	\$ (60,703)

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART
THEREOF.

BALDWIN MUTUAL INSURANCE COMPANY, INC.
CAPITAL AND SURPLUS ACCOUNT
For the Years Ended December 31, 2002, 2001, 2000, 1999, and 1998

	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>
Surplus as regards policyholders, December 31, prior year	\$ <u>8,010,447</u>	\$ <u>7,192,985</u>	\$ <u>6,548,491</u>	\$ <u>5,759,174</u>	\$ <u>6,014,901</u>
Gains and (losses) in Surplus					
Net income	\$ 306,474	\$ 647,230	\$ 530,707	\$ 843,985	\$ (60,703)
Net unrealized capital gains or losses	(238,698)	164,392	103,374	(72,265)	(182,653)
Change in non-admitted assets:					
Per Company	(19,903)	5,840	10,413	17,597	(12,371)
Per Examination (Note 16)	(1,489,474)	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Change in surplus as regards policyholders for the year	\$ <u>(1,441,601)</u>	\$ <u>817,462</u>	\$ <u>644,494</u>	\$ <u>648,279</u>	\$ <u>174,186</u>
Surplus as regards policyholders, December 31, current year	\$ <u>6,568,846</u>	\$ <u>8,010,447</u>	\$ <u>7,192,985</u>	\$ <u>6,548,491</u>	\$ <u>5,759,174</u>

THE NOTES TO THE FINANCIAL STATEMENTS ARE AN INTEGRAL PART
THEREOF.

NOTES TO FINANCIAL STATEMENTS

Note 1 – Bonds

\$46,901

The captioned asset is the same as was reported by the Company in its 2002 Annual Statement and \$215 more than the \$46,686 amount determined by this examination.

The examination of bond amortization workpapers determined that the Company used the straight-line amortization method when amortizing bonds. As of December 31, 2002, the Company admitted two bonds with an aggregate value of \$46,901, which was calculated by amortizing the discount/premium by the straight-line amortization method. The Company should be using the scientific interest method as prescribed in *SSAP No. 26*, paragraph 6, of the NAIC's Accounting Practices and Procedures Manual, which states:

“Amortization of bond premium or discount shall be calculated using the scientific (constant yield) interest method taking into consideration specified interest and principal provisions over the life of the bond.”

The examiners recalculated the amortization of the bonds using the scientific method, and determined that the Company had overstated the value of bonds by a total of \$215. The overstatement of the value has been deemed immaterial for the purposes of this examination, and no changes were made to the financial statements in this report.

At December 31, 2002, the Company did not maintain an approved custodial agreement in accordance with ALA. ADMIN. CODE 482-1-077 (2003). However, subsequent to the examination date, on October 20, 2003, the Company obtained approval of the custodial agreement from the Commissioner of the ALDOI.

Note 2 – Preferred stocks

\$222,299

The captioned amount is the same as reported on the 2002 Annual Statement. A review of the NAIC's *JumpStart Report* noted one designation exception. The Company selected “P1L” to identify its TECO Energy issue, purchased in August 2002, as perpetual preferred stock of the highest quality rating, and indicating that the unit price was listed on the New York Stock Exchange, the American Stock Exchange or on the NASDAQ National Market System. A search of the NAIC Security Valuation Office's Valuation of Securities database evidenced that the security was

listed as a common stock, valued at \$19.90 per share but, because of its features and characteristics was not assigned a designation.

The TECO Energy issue, which the Company classified as a preferred stock, had certain characteristics, such as a Mandatorily Convertible feature, that caused the SVO to classify it as a common stock. That feature requires that the investor convert each unit of preferred stock into units of common stock at a specified date in the future. Therefore, the Security Valuation Office analysts classified this security as a common stock in accordance with Part Seven, Section 1(c)3(f) of the Security Valuation Office's Purposes and Procedure Manual. The Company should have classified its 1,000 shares of the security as common stock on *Schedule D – Part 2 – Section 2*, of the 2002 Annual Statement. The admitted value of \$19,900 was a misclassification and had no effect on the value of the security. An adjustment to the financial statements was not necessary.

Note 3 – Common stocks

\$2,759,631

The above captioned amount is \$10,368 less than the \$2,769,999, reported on the Company's 2002 Annual Statement. As of December 31, 2002, the following three stocks were held out-of-state:

STOCK	NO. of SHARES	LOCATION	VALUE
Delphi	138	New York	\$ 1,111
General Motors	100	Rhode Island	3,686
Stewart Enterprises	1000	Georgia	5,571
		Total	<u>\$ 10,368</u>

By maintaining these stocks outside of the state, the Company is in violation of ALA. CODE § 27-27-29(b) (1975), which states:

“Every domestic insurer shall have, and maintain...in this state and shall keep therein complete records of its assets, transactions and affairs...”

Because the Company did not comply with previous examination recommendations requiring that stocks be maintained in Alabama in accordance with the aforementioned section of the *Alabama Insurance Code*, the \$10,368 statement value will not be admitted for the purposes of this examination.

On February 12, 2003, subsequent to the examination date, the Company transferred 69 Delphi shares and all of the General Motors shares to its custodial account with

The Trust Company of Sterne, Agee, and Leach, Inc. The Stewart Enterprises shares were sold on March 13, 2003. The Company still maintains 69 shares of Delphi out-of-state with The Bank of New York.

Furthermore, the Company did not retain complete records of the majority of its security transactions in accordance with ALA. CODE § 27-27-29(a) (1975).

It was noted that the Company had recorded all of its dividend reinvestment acquisitions listed on *Schedule D - Part 3*, of the 2002 Annual Statement, as occurring on December 31, 2002. A review of the workpapers provided by the Company indicated that many of the securities were purchased at various times throughout the year. The NAIC's Annual Statement Instructions state:

"Each issue of bonds or stocks acquired at public offerings on more than one date may be totaled on one line and the date of the last acquisition inserted."

The Company should have reported the last date of acquisition for each security issue purchased during the year.

The review of arrangements between the Company and E*Trade Securities, LLC, indicated that the Company's investment officer placed numerous trades through E*Trade using an on-line margin account. The margin account allows the Company to purchase securities by borrowing funds up to the amount held in the account. Apparently, the Company has not actively written covered calls but maintains the ability to do so as a hedge against falling stock prices. Management indicated that Company has positioned itself to have the financial tools available to counter down turns in the stock market, and that this practice is a growing trend in quality financial management and planning. The existence of such an account exposes the Company to undue risk and is an unusual practice not ordinarily utilized in the insurance industry. The margin account had no outstanding loan balances as of December 31, 2002.

Note 4 – Mortgage loans on real estate

\$180,024

The above captioned asset is the same as the \$180,024 reported on *Schedule B – Part 1* on the 2002 Annual Statement.

A review of mortgage loans determined that the Company valued one mortgage loan with the unpaid principal balance of \$27,461, when it was originally appraised at only \$25,000. ALA. CODE § 27-41-29(1) (1975) states that:

“...no such mortgage loan or loans when made shall exceed 75 percent of the fair value of the real estate or leasehold; except that loans made on single family dwellings shall not exceed 80 percent of the fair value of the property. “Fair value” shall be determined by a competent appraiser or appraisers.”

Therefore, the Company cannot make a single dwelling mortgage loan in excess of 80 percent of the fair value, or \$20,000 ($\$25,000 \times 80\%$). Accordingly, the \$7,461 amount in excess of 80 percent of the fair value, ($\$27,461 - \$20,000$) should not have been admitted for the purposes of this examination. It was noted that this property had no insurance policy because there was no building to insure; the building was lost in a fire. Because the building was destroyed and not rebuilt, and there was no subsequent reappraisal on the property, the existing mortgage loan balance cannot be identified as an admitted asset in accordance with *SSAP No. 4*, of the NAIC's Accounting Practices and Procedures Manual. The aggregate \$27,461, which should be non-admitted, was not considered material for the purposes of this examination, and no changes were made to the financial statements in this report.

During the review of mortgage loan interest due and accrued, it was discovered that as of 1998, the Company admitted \$6,393 of mortgage loan interest due and accrued. Interest on two mortgage loans had accumulated for more than 180 days. *SSAP No. 37*, paragraph 14, of the NAIC's Accounting Practices and Procedures Manual states:

“If a loan in default has any investment income due and accrued which is 180 days past due and collectible, the investment income shall continue to accrue, but all interest related to the loan is to be reported as a nonadmitted asset.”

The Company should not have admitted this amount on its 1998 Annual Statement. During 1999, the Company inappropriately capitalized \$5,710, the unpaid past due interest balance of one of the loans.

Note 5 – Real estate

\$2,454,313

The captioned amount is \$859,594 less than the \$3,313,907 reported in the Company's 2002 Annual Statement. The following schedule details the amounts not admitted as a result of this examination and each item is discussed below.

<u>DESCRIPTION</u>	<u>PER</u> <u>2002 A/S</u>	<u>PER</u> <u>EXAMINATION</u>	<u>DIFFERENCE</u>
<i>Properties occupied by the company:</i>			
Mobile Office	\$ 217,306	\$ 0	\$ (217,306)
Home Office	<u>2,861,413</u>	<u>2,303,000</u>	<u>(558,414)</u>
<i>Total Properties occupied by the company</i>	<u>\$3,078,720</u>	<u>\$2,303,000</u>	<u>\$ (775,720)</u>
<i>Properties held for the production of income:</i>			
Residential rented as commercial	\$ 151,313	\$ 151,313	\$ 0
Commercial Lots	<u>83,874</u>	<u>0</u>	<u>(83,874)</u>
<i>Total Properties held for the production of income</i>	<u>\$ 235,187</u>	<u>\$ 0</u>	<u>\$ (83,874)</u>
TOTALS	<u>\$3,313,907</u>	<u>\$2,454,313</u>	<u>\$ (859,594)</u>

Lack of Appraisals

In order to determine that properties were valued accurately, real estate appraisals for *Properties occupied by the company* and *Properties held for the production of income* were reviewed. Appraisals were not provided for six properties; these included the Mobile Office, valued at \$217,306, and five commercial lots, totaling \$83,874, for an aggregate value of \$301,180.

SSAP No. 40, paragraph 12, of the NAIC's Accounting Practices and Procedures Manual requires that:

“For all properties held for the production of income, the reporting entity must maintain an appraisal that is no more than five years old as of the reporting date.”

In addition, ALA. CODE § 27-37-7(b) (1975), states that:

“Other real property held by an insurer shall not be valued at an amount in excess of fair value as determined by recent appraisal. If valuation is based on an appraisal more than three years old, the commissioner may at his discretion call for and require a new appraisal in order to determine fair value.”

Utilizing the above guidelines, the real estate properties without appraisals, with a total value of \$301,180, were not admitted for the purposes of this examination. It was noted that the previous examination recommended that the Company obtain appraisals on its real properties. After the conclusion of the examination, the Company provided

the examiners with an appraisal, dated February 5, 2004, for the Mobile Office property.

Home Office Property

The Company reported its Home Office property at current market value, based on a 1999 appraisal. A "Schedule of Exempt Assets" allowed the Company to carry this property at the market value of \$2,303,000, as of August 17, 1993. Since that time, the Company has annually been increasing, or writing up the value to current market value. At December 31, 2002, the Company recorded the admitted value of the Home Office property at a market value of \$2,861,414. The Company's President stated that "We followed the previous instructions of the Department to increase the carrying value." No supporting documentation to evidence this valuation methodology was provided during the course of the examination. Consequently, this examination has determined that the \$2,861,414 reported value overstated the 1993 value of \$2,303,000, by \$558,414, and the latter amount has been not admitted for the purposes of the examination.

The adoption of Codification in January of 2001, and the repeal of ALDOI *Regulation No. 18*, in April 2001, established statutory accounting principles for real estate investments. The NAIC's Annual Statement Instructions state that home office real estate must not exceed actual cost, plus capitalized improvements, less normal depreciation. Accordingly, the Company should have carried the Home Office property on *Schedule A* of the 2002 Annual Statement at \$978,616, the depreciated cost. The examiners have only reduced the admitted value of the Home Office property to \$2,303,000, in this report, per the previously mentioned "Schedule of Exempt Assets."

The examiners recommend that the Company either:

- (1) attempt to obtain a permitted practice from the ALDOI in order to amortize the difference between \$2,303,000, and \$978,616, over a five-year period, and then carry the property at depreciated cost from that point forward; or
- (2) reduce the property to depreciated cost in its next financial statement filed with the ALDOI, per NAIC Annual Statement Instructions.

Note 6 – Cash and short-term investments

\$6,931,487

The captioned amount is \$183,267 less than the \$7,114,754 that was reported by the Company in its 2002 Annual Statement. The review of the cash account confirmations determined that the Company's E*Trade Account balance as of December 31, 2002, totaled \$183,267, and was held in Rancho Cordova, CA. The Company is in violation

of ALA. CODE § 27-27-29(b) (1975) which states, "Every domestic insurer shall have, and maintain, its assets in this state..." The account balance of \$183,267 will be not admitted for the purposes of this examination.

It was noted that the fair value of the collateral pledged by Colonial Bank in relation to the repurchase agreement was \$5,178,449, which is \$103,517 less than the 102 percent collateral requirement. *SSAP No. 45*, of the NAIC's Accounting Practices and Procedures Manual states:

"The collateral requirements for repurchase and reverse repurchase agreements are as follows:

Repurchase Transaction

- a. The reporting entity shall receive as collateral transferred securities having a fair value at least equal to 102 percent of the purchase price paid by the reporting entity for the securities. If at anytime the fair value of the collateral is less than 100 percent of the purchase price paid by the reporting entity, the counterparty shall be obligated to provide additional collateral, the fair value of which, together with fair value of all collateral then held in connection with the transaction, at least equals 102 percent of the purchase price."

In addition, the examination determined that the Company did not report its repurchase agreement transactions under item 19.2 of the Investment section of the *General Interrogatories*, as instructed by the NAIC's Annual Statement Instructions.

The Company reported the repurchase agreement held with Colonial Bank as cash under *Schedule E – Part 1*, of the 2002 Annual Statement. *SSAP No. 45*, of the NAIC's Accounting Practices and Procedures Manual states that "The amount paid for the securities shall be reported as a short-term investment..." The Company should have reported the repurchase agreement as a short-term investment under *Schedule DA*, as required by the NAIC's Annual Statement Instructions and the aforementioned SSAP.

Furthermore, the Company was not in compliance with *SSAP No. 2*, of the NAIC's Accounting Practices and Procedures Manual, which states, in pertinent part:

"All investments with remaining maturities (or repurchase dates under repurchase agreements) of one year or less at the time of acquisition (excluding those investments classified as cash equivalents as defined in paragraph 3) shall be considered short-term investments."

Note 7 – Premiums and agents' balances in course of collection**\$ -0-**

The captioned amount is \$436,245 less than the \$436,245 reported by the Company in its *Annual Statement as of December 31, 2002*, and is composed of the items shown in the following tables. The details of each are explained below.

<u>DESCRIPTION</u>	<u>AMOUNT</u>
I. Uncollected premium balances (agents' balances)	\$ 513,230
II. Commissions payable	<u>(76,985)</u>
TOTAL	<u>\$ 436,245</u>

I. Uncollected premium balances

The Company's premiums receivables register consisted of uncollected premiums on a policy-by-policy basis totaling \$513,230. The uncollected balances were not aged and the receivables did not contain the aging elements [e.g.: 1) effective date, 2) expiration date, 3) policy term] required to determine the due date of the premiums. A sample of policies was taken from the uncollected premium balances report, and the original records (application files) for each of the items were reviewed. The examination determined that the policy contracts did not contain installment options or the due date of subsequent installments once the original premium was paid by the policyholder. The review of the sample also indicated that the Company recorded uncollected premiums on policies which were not in-force or due for renewal before the year-end.

The Company inappropriately reported the \$436,245 under *Premiums and agents' balances in course of collection*. According to the NAIC's Annual Statement Instructions, installments booked by the Company are reported under *Premiums, agents' balance and installments booked but deferred and not yet due*.

Uncollected premiums from policyholders was inappropriately reported on asset line 10.1: *Premiums, agents' balances in course of collection* instead of under line 10.2: *Premiums, agents' balances and installments booked but deferred and not yet due*. In order to verify that the Company had included installment balances on those policies that were in-force, an in-force listing was required. Company management indicated that a premium in-force listing was not maintained in either electronic format or in hard copy.

In order to address the aforementioned issues, the Company should maintain complete verifiable records which include, but are not limited to the following:

- Uncollected should include the expiration date or policy term in addition to the existing fields, and maintained in electronic format for the examiners' review.
- Policy contracts should allow the installments option, and the contractual due date of the installments should be defined.
- An electronic policy in-force listing should be maintained for the examiners' review.

ALA. CODE § 27-27-29(a) (1975) states:

“Every domestic insurer shall have, and maintain, its principal place of business and home office in this state and shall keep therein complete records of its assets, transactions and affairs in accordance with such methods and systems as are customary or suitable as to the kind, or kinds, of insurance transacted.”

The uncollected premium should be aged in accordance with *SSAP No. 6*, of the NAIC's Accounting Practices and Procedures Manual, and balances over 90 days should be not admitted for the purpose of statutory reporting. After calculating the not admitted amount, an evaluation should be made of the remaining admitted asset in accordance with *SSAP No. 5*, of the NAIC's Accounting Practices and Procedures Manual, and if it is probable the balance is uncollectible, the total uncollectible amount should be written off and charged to income in the period the determination is made.

II. Commissions payable

The \$76,985 amount was agents' commission, and was calculated at the rate of 15 percent of \$513,230. According to the NAIC's Annual Statement Instructions, the Company should have recorded commission payable under *Commissions payable, contingent commissions, other similar charges*. (See “Note 11 – Commission payable, contingent commissions, other similar charges.”)

Note 8 – Federal and foreign income tax recoverable

\$ -0-

The referenced amount is the same as was reported by the Company in its 2002 Annual Statement but \$142,535 less than the \$142,535 amount determined by this examination. The difference was not considered material for the purposes of this examination, and no changes were made to the financial statements.

The Company files a consolidated tax return with GCTIC, its majority-owned subsidiary. A detailed discussion of the *Tax Allocation Agreement* may be found in the

HOLDING COMPANY AND AFFILIATE MATTERS section of this report, under the "Transactions and Agreements with Affiliates" caption. The review of the tax return and workpapers indicated that all categories of taxable income were included in the tax return.

It was noted that Deferred Tax Assets (DTA) amounted to \$142,535 (\$179,489 for prior years, less the current year adjustment of \$36,954). That amount was not reported in the Annual Statement by the Company.

According to *SSAP No. 10*, paragraphs 5-7, of the NAIC's Accounting Practices and Procedures Manual, DTA and Deferred Tax Liabilities (DTL) are reported in the Annual Statement. In addition, the NAIC's Annual Statement Instructions stipulate that DTAs should be included in asset line 15: *Federal and foreign income tax recoverable and interest thereon*, on the balance sheet. The current income tax asset met the definition of an asset as specified in *SSAP No. 4 (Assets and Nonadmitted Assets)* of the NAIC's Accounting Practices and Procedures Manual, and should have been admitted in accordance with *SSAP No. 10*, paragraph 10, of the NAIC's Accounting Practices and Procedures Manual.

Note 9 – Aggregate write-ins for other than invested assets **\$146,389**

The captioned amount is the same as reported by the Company in its *Annual Statement as of December 31, 2002*, but \$11,543 more than the \$134,847 amount determined by this examination. The entirety of the \$23,084 difference was in Cash Surrender Value (CSV) life insurance, which is discussed later in this note.

The balance sheet amount for *Aggregate write-ins for other than invested assets* was \$569,429, of which \$146,389 was admitted for the purposes of statutory reporting. The following schedule details the specific items included in the asset:

DESCRIPTION	ASSET	NOT ADMITTED	NET ADMITTED
CSV LIFE INSURANCE	\$145,474	\$	\$ 145,474
OTHER RECEIVABLES	147,301	146,386	915
MEMBERSHIPS	1,000	1,000	0
INVENTORY LOSS MITIGATION	170,248	170,248	0
RIVIERA REFURBISHING LLP	<u>105,406</u>	<u>105,406</u>	<u>0</u>
	<u>\$569,429</u>	<u>\$423,040</u>	<u>\$ 146,389</u>

CSV Life Insurance

The CSV on policies owned by the Company on four of its officers and directors was \$145,474, which was admitted by the Company for the purposes of statutory reporting. A policy on the Company's President, as the insured, had a CSV of \$23,084, as of the examination date. While the Company was the owner of the policy, the benefits were to be shared equally by the Company and the President's wife. According to the guidance provided by *SSAP No. 21*, paragraph 5, of the NAIC's Accounting Practices and Procedures Manual:

"The cash surrender value of the life policies where the reporting entity is the owner and beneficiary is similar to a cash deposit that is realizable on demand. As such, the cash value... shall be reported as admitted asset."

Since the President's wife and the Company were to share equally as beneficiaries of the policy's CSV, only the Company's half of the \$23,084 CSV, or \$11,542, was deemed to be admissible in accordance with the above mentioned SSAP. The \$11,542 not admitted portion was considered immaterial, and no changes were made to the financial statements for the purposes of this examination.

The \$423,040 not admitted amount, detailed in the above schedule, was charged directly to surplus, thereby inflating the net operating profit. For the purpose of this examination, the following amounts will be reclassified and charged to operations (*Statement of Income*):

<u>DESCRIPTION</u>	<u>AMOUNT</u>
Prepaid premium taxes	\$108,828
Memberships	1,000
Inventory loss mitigation	<u>170,248</u>
TOTAL	<u>\$280,076</u>

Prepaid premium taxes

The referenced \$108,828 in premium taxes was included in the reported \$147,301 total for "OTHER RECEIVABLES" in the Annual Statement and paid to the ALDOI on 2002 premiums written. Guidance provided by *SSAP No. 29*, of the NAIC's Accounting Practices and Procedures Manual:

"A prepaid expense is an amount which is paid in advance of receiving future economic benefits anticipated by the payment. Prepaid expenses generally meet the definition of assets in *SSAP No. 4 - Assets and Nonadmitted Assets* (SSAP No. 4)."

As of December 31, 2002, the Company received the anticipated economic benefit

from the payments thereby not meeting the definition of a prepaid expense, nor the definitions of assets and nonadmitted assets. Transactions which do not give rise to assets as stipulated in *SSAP No. 4*, of the NAIC's Accounting Practices and Procedures Manual, are not reported in the balance sheet, but charged to operations in the period the transactions occur in accordance with the aforementioned SSAP.

Memberships

The Company's records indicated that the \$1,000 amount, captioned "Memberships," did not meet the description of assets and nonadmitted assets as defined by *SSAP No. 4*, of the NAIC's Accounting Practices and Procedures Manual and was, accordingly, charged to operations for the purposes of this examination.

Inventory loss mitigation

Inventory loss mitigation in the amount of \$170,248, at December 31, 2002, is the result of purchases made by the Company for repairs and settlement of losses arising from future claims. The examiners could not determine how the Company would have economic benefit from the stated asset or the ability of the asset to meet policyholders' obligations. Although the Company charged the not admitted asset against surplus, the asset should be treated as impaired and recorded by a charge to operations in accordance with *SSAP No. 5*, paragraph 7, of the NAIC's Accounting Practices and Procedures Manual.

Note 10 – Losses

Loss adjustment expenses

\$406,199

116,801

\$523,000

The referenced liability is \$102,276 more than the \$420,724 reported by the Company in its 2002 Annual Statement for *Losses and Loss adjustment expenses* (LAE). The actuarial examiners determined that the net loss and LAE reserves as of the examination date were outside a range of reasonable reserve estimates. An in-depth review of the allocation between loss and LAE reserves indicated that the net loss reserves were approximately equivalent to the examination estimate. The indicated deficiency applied almost entirely to net LAE reserves. The following schedule reflects the reported Annual Statement amounts and adjustments to net reserves for the purposes of this examination:

	PER 2002 A/S	RECOMMENDED ADJUSTMENT	PER EXAMINATION
LOSSES	\$406,199	\$ 0	\$406,199
LAE	<u>14,525</u>	<u>102,276</u>	<u>116,801</u>
TOTAL	<u>\$420,724</u>	<u>\$102,276</u>	<u>\$523,000</u>

Due to the observed consistent reserve deficiencies over the examination period, the actuarial examiners reviewed the Company's reserving procedures in detail. The methods for established net-of-reinsurance reserves for loss and defense and cost containment expenses (DCCE) are described in the following subsections of this note.

Case Reserves

The Company's claims adjusters' estimated loss and DCCE case reserves of \$20,838 for open claims as of December 31, 2002. The Company did not book that amount as case reserves in the 2002 Annual Statement. The amount booked in the 2002 Annual Statement was \$339,477, which was the sum of the following two amounts:

- \$257,777 for losses and DCCE paid in January 2003 on claims incurred in 2002 and prior accident years; and
- \$81,700 for case loss and DCCE reserves as of the end of January 2003, on claims incurred in 2002 and prior accident years.

Bulk and Incurred But Not Reported (IBNR) Reserves

The Company booked \$71,248 of bulk and IBNR loss reserves in the 2002 Annual Statement. This amount is equal to the average of two estimates of bulk and IBNR reserves for total losses and DCCE.

One of the bulk and IBNR estimates resulted from an analysis of historical lag ratios of paid losses and DCCE. Specifically, the numerator of each ratio was calculated as all loss and DCCE payments made for a given accident year after the end of the accident year, less the case reserves as defined (for the Annual Statement) above. The denominator is equal to the calendar year (corresponding to the given accident year) reported losses and DCCE. The product of an average of the ratios for many years and accident year 2002 paid loss and DCCE produced the estimate bulk and IBNR reserves for this method. Some of the theoretical flaws in this method are described below:

- The method roughly estimated bulk and IBNR reserves for only accident year 2002. Any expected development on accident years 2001 and prior was excluded from the result.
- The ratio was derived using calendar year reported losses and DCCE in the denominator. However, the resulting average ratio is applied

to accident year paid losses and DCCE. It would have been more appropriate to apply the resulting ratio to calendar year 2002 reported losses and DCCE.

- The numerator of the ratio excluded payments expected subsequent to year-end 2002. For instance, the ratio for 2001 includes only one year of paid development. For this reason, the actuarial examiners suspect that the resulting ratios for 2000 and 2001 are both understated.

Each of these three issues contributes to the understatement of resulting bulk and IBNR reserves.

The second bulk and IBNR reserve estimate resulted from a development triangle analysis. The data are labeled as incurred data by accident year; however, accident year 2002 data were not included. Although the actuarial examiners were not able to reconcile the data in the first column (as of 12 months) to the other loss and DCCE workpapers, the Company's accountant explained that the first valuation represents calendar year reported losses and DCCE. The second valuation represents the sum of the first valuation losses and DCCE and the accident year payments made from 24 to 36 months after the beginning of the accident year. This is very unusual since the payments made from 13 to 24 months appear to be completely excluded from the analysis.

The method roughly produces an estimate of reserves as of December 31, 2001, excluding all payments made in calendar year 2002. Assuming that the reserves for payments beyond 24 months of development are consistent from year to year, this may represent a reasonable estimate for the corresponding reserve as of year-end 2002. However, the expected payments during 2003 are theoretically excluded from the result. Since booked case reserves include payments made in January of 2003, the total reserves from this method exclude expected payments from February through December of 2003. This results in a significant understatement of estimated bulk and IBNR reserves resulting from this method.

Again, the average of the resulting bulk and IBNR estimates from the two methods was selected for the 2002 Annual Statement. The total bulk and IBNR reserves for losses and DCCE were booked as bulk and IBNR loss reserves in the Annual Statement.

All of the loss and DCCE reserve calculations were conducted with data that are net of reinsurance. The only ceded reserve was a negative ceded case loss reserve of \$10,000. It is the actuarial examiners' understanding that this represents an amount

that the Company was overpaid by the reinsurer. It was noted that 2002 Annual Statement net paid losses should have been net of the amount due the reinsurer. As a balancing entry, the 2002 Annual Statement should have also reflected a contra-asset for reinsurance recoverable on paid losses and LAE.

The loss and DCCE reserve calculations were also net of salvage and subrogation (S&S) recoveries, resulting in reserves that are net of anticipated S&S recoverable. Although S&S is not material for the Company, it was noted that Section II (*Recoveries must be reduced to cash before credit is taken*) of ALDOI Regulation No. 61, requires domestic insurers to book reserves gross of anticipated S&S recoveries.

The Company did not separately estimate or book any reserves for adjusting and other (A&O) expenses. When this issue was reviewed with the Company's accountant, it was explained that some of the claims adjustment expenses are paid to independent claims adjusters. Those paid expenses are included with DCCE in the Annual Statement rather than A&O. For this reason, some of the adjuster expenses are theoretically contemplated in the analysis of loss and DCCE reserves.

The Company does not allocate any of the remaining claims adjustment or general expense payment to LAE. Finally, the Company does not set up any liability for remaining A&O expenses.

The Company's accountant indicated that the same methods were used to establish reserves for the past several years. In the actuarial examiners' opinion, the methods consistently underestimate loss and DCCE reserves. The booked A&O reserve of "zero" also contributes to the overall reserve deficiency. Finally, in the opinion of the actuarial examiners, the booked ceded reserves of \$(10,000) do not represent a reasonable estimate of ceded loss and LAE reserves. The Company booked its best estimate of the unpaid claims liability, in accordance with *SSAP No. 55*, of the NAIC's Accounting Practices and Procedures Manual. However, that estimate was flawed, in the actuarial examiners opinion, due to the methods used to estimate the liability. For these reasons, the examiners recommend that the Company establish reasonable net and gross loss and LAE reserving methods and results.

Actuarial Reserve Opinion

Matthew P. Merlino, FCAS, MAAA, of Merlino & Associates, Inc., prepared the reserve opinion supporting the 2002 Annual Statement loss and LAE reserves. The actuarial examiners reviewed the reserve opinion and found that it included generally standard language. It was noted that the direct and assumed loss reserve amount in the opinion was \$395,000, whereas the actual booked amount in *Schedule P* was \$396,000; the difference was not material. The other reserve amounts listed in the

opinion matched the 2002 Annual Statement.

A review of the reserve study supporting the reserve opinion noted that the opining actuary used standard paid and reported development methods to estimate ultimate losses and DCCE on a net of reinsurance basis. All of the business was combined for this analysis, and presented in the triangles net of both reinsurance, and S&S. Final ultimate losses were selected as the average of the results of the two methods. Estimated reserves were calculated as the difference between the selected ultimate losses and DCCE, and actual paid data as of December 31, 2002.

The opining actuary approximated A&O reserves by applying an industry factor to one-half of case reserves and all of the IBNR reserves. This is a generally accepted method that assumes that one-half of the A&O expenses are paid when a claim is opened, and the remaining one-half when it is closed. The actuarial examiners compared the actuary's selected ratio of A&O to loss and DCCE with the industry data and found that the five percent selection was reasonable. However, given that some of the Company's adjuster expenses were already contemplated in the DCCE reserve estimates, the selected A&O ratio may be conservative.

It is the actuarial examiners' opinion that the opining actuary's net loss and LAE reserving methods and selections were reasonable. The opining actuary compared final loss and LAE reserves, net of reinsurance and S&S, to the Company's booked reserves. The actuary's estimate was approximately \$67,000, or 16 percent, greater than booked reserves. Given the short-tailed and consistent development of BMIC losses and DCCE, the difference suggests that booked reserves were outside a reasonable range of reserves. However, the actuary demonstrated that the indicated deficiency was not material in relation to the Company's surplus. Mr. Merlino stated that this was the materiality standard that was applied in the reserve opinion, which is an acceptable criterion for issuing a favorable statement of actuarial opinion according to the Actuarial Standard of Practice (ASOP #36 - Statements of Actuarial Opinion Regarding Property/Casualty Loss and Loss Adjustment Expense Reserves).

The reserve study also included a development triangle analysis of S&S recoveries; however, it was not clear why this analysis was included since the final net loss and LAE reserves were presented on a net-of-S&S basis. As noted previously Alabama law requires reserves to be booked gross of anticipated S&S, and the amount of S&S for this Company was not material.

The reserve study did not include an analysis of gross or ceded loss and LAE reserves. In his report, the opining actuary stated that direct indicated reserves were equal to the new reserves, plus the Company's ceded reserve amounts. Since the only booked

ceded reserves were negative, this resulted in gross reserves that were less than net reserves. In further discussions, the actuary indicated that the ceded bulk and IBNR reserves were, in his opinion, not material. Consequently, a separate analysis of gross would not be necessary. The actuarial examiners generally concur with this assessment but noted that the result in the 2002 Annual Statement appears unreasonable, due to the negative ceded reserve amount.

Preparation of Annual Statement Schedule P

The actuarial examiners reviewed the year-end 2002 *Schedule P* workpapers provided by the Company. Although there were not any material errors, there are several issues regarding the preparation of *Schedule P*:

- Reinsurance recoverable on paid losses should have been reflected in net paid losses but was incorrectly included in ceded case loss reserves.
- Paid independent adjuster expenses were booked as DCCE rather than correctly included in the A&O category. General expenses and internal claims adjuster expense payments were not included in either DCC or A&O.
- As previously discussed, booked case reserves actually represent reported development through the end of January of 2003.
- All bulk and IBNR reserves were booked as loss reserves, rather than allocated to the loss and DCCE components.
- The Company did not book any A&O reserves.

Reasonableness of established liabilities

The results of the independent examination reserve analyses indicated that the total booked loss and LAE reserves were outside a reasonable range of reserve estimates. Although the difference is not material relative to surplus, it is material in relation to overall booked reserves. It is also material in consideration of the relative ease of predicting development on BMIC claims. It was determined that nearly all of the indicated deficiency was attributable to LAE reserves. *SSAP No. 's 5 and 55*, of the NAIC's Accounting Practices and Procedures Manual establish accounting principles for the defining, accounting and recording of liabilities for unpaid losses and LAE for Property and Casualty contracts.

DCCE and A&O expenses

SSAP No. 55, paragraph 5, of the NAIC's Accounting Practices and Procedures Manual stipulates that reserves should be set for all incurred claims as of the accounting date, whether reported or unreported as of that date. Further, it addresses the correct categorization of LAE reserves into DCCE versus A&O components within the Annual Statement. The following were determined as a result of the

actuarial review:

- Case reserves were correctly allocated between losses and LAE; however, the LAE case reserves were not further allocated between DCC and A&O. The total LAE case reserves were booked as DCC in the 2002 Annual Statement.
- The Company booked bulk and IBNR reserves reflected losses, DCC, and a portion of A&O. All bulk and IBNR reserves were booked as losses in the 2002 Annual Statement.
- The portion of A&O not considered within booked reserves was the ULAE reserve, or reserve for internal claims adjustment and general claims-department-related expenses.

Establish liability using actuarial standards

Paragraph 8, of SSAP No. 55, of the NAIC's Accounting Practices and Procedures Manual simply states that the liability for claim reserves and claim liabilities, unpaid losses and loss/claim adjustment expenses should be established using appropriate actuarial standards. Since the Company's booked LAE liability only represents payments made in January of 2003 on 2002 and prior accident year claims, the booked liability did not represent a reasonable estimate of the LAE associated with unpaid claims as of December 31, 2002.

Maintenance of claims records

The Company's paid losses and paid LAE electronic files for the five years under examination were obtained from the Company. The files were reviewed for significant information pertaining to claims reported by insureds. The following discrepancies were noted:

- Claim number was not recorded on the claim report in each of the 47 sampled items.
- Report date could not be located on the claim report in five of the 47 items.
- Two claims had the same claim number (loss report date was the same).
- A claim check was voided but data in the file was not updated.
- One claim in litigation was settled in the year 2000. Review of the payment history indicated that the payments on the claim resulted in a cumulative payment of \$62,088.24 (claim settlement and legal expenses). The Company's records indicated that the Company had

included entries to void certain checks; however, one for \$35,281.39 did not have a corresponding payment entry.

Recording reported claims appropriately and accurately is the first step to settle claims in a timely manner. Accurate and complete claims information facilitates the examiners to validate the loss database to the original claims records. The examination determined that the Company's database did not contain the loss report date, which is significant in determining the timeliness in claim settlement, analyzing loss data for reserving, and estimation of IBNR reserve.

The Company's database included insured's policy information, premiums payments and claims information. Various reports are generated and utilized by the Company to prepare financial statements. Since computers are utilized by the Company in day-to-day operations, it would be a good business practice to save the database in an EDP format to be retrieved when necessary for financial audits.

EDP files are one of the tools by which requested information can be provided for the purposes of statutory audits. It is necessary that the information provided to the examiners be complete records of transactions which includes, but is not limited to, the loss report date. ALA. CODE § 27-27-29 (1975) requires that the Company to keep complete records of its assets, transactions and affairs, and ALDOI *Regulation No. 118*, stipulates that all books, records, documents and other business records be readily available for examination and maintained for no less than five years.

Reserve test work

A sample of 47 items was selected from the reserve listings as of the examination date. It was noted that the total of the reserve amount for the sample items was \$171,968; however, the paid claims review for the same items indicated that a total of \$227,661 had been paid in losses and LAE. It was also noted that complete and accurate claims documentation was not maintained in these files in accordance with ALA. CODE § 27-27-29 (1975). Discrepancies included the following:

- One file did not have the claim report.
- Two files contained duplicate, not original claim reports.
- One file contained various report dates.
- One file did not contain the claim information.

Presentation and allocation of loss expenses (SSAP No. 70)

The 2002 Annual Statement LAE payments and reserves were not booked in strict

accordance with SSAP No. 70, of the NAIC's Accounting Practices and Procedures Manual. Said statement establishes accounting principles for the presentation and allocation of certain expenses into general categories. The Company's paid LAE and LAE reserves reflected only allocated loss adjustment expenses (ALAE), and did not include unallocated loss adjustment expenses (ULAE). The booked DCCE actually contained all ALAE, which included some A&O expenses related to independent claims adjusters expenses. The Company did not book any A&O payments or reserves in the 2002 Annual Statement. ULAE reserves were not contemplated in the booked total LAE reserves.

**Note 11 – Commissions payable, contingent commissions, and
other similar charges**

\$256,393

The captioned amount is the same as reported by the Company in its *Annual Statement as of December 31, 2002*, but \$4,233 more than the \$252,160 amount determined by this examination.

The \$256,393 amount reported by the Company consisted of bonus payments to agents for favorable loss experience. The method utilized to calculate the bonus expense (reserve) at year-end was consistent with prior years. The commission payable to agents at year-end was not included in the referenced liability line in accordance with the NAIC's Annual Statement Instructions but reported as an adjustment to agents' balances. The methodology utilized by the Company to calculate agents' commission was the same utilized to calculate the year-end commission payable. A review of the detailed listing of commission payments indicated that 100 agents received performance bonuses aggregating at \$251,160, which was \$4,233 less than the \$256,393 in actual reserves. The difference was not considered material, and no changes were made to the financial statements in this report.

Testing of the Company's agents' balances records determined that \$76,984 in commissions due to agents on deferred installment premiums was netted for the purposes of statutory reporting. The NAIC's Annual Statement Instructions require that commissions payable be reported as a liability. The \$76,984 amount is simply a reclassification issue. Since there would be no effect on the Company's surplus, no change was made to the financial statements in the examination report. Additional discussion concerning this matter may be found previously in this section under the "Note 7 – Premiums and agents' balances in course of collection" caption.

Note 12 – Other expenses

\$465,992

The referenced amount is \$131,315 more than the \$334,677 reported by the Company in its *Annual Statement as of December 31, 2002*.

The NAIC's Annual Statement Instructions requires that the Company establish adequate accruals for *Other expenses* in its financial statements. For the purposes of this report, the captioned amount includes an additional \$131,315 in liabilities determined as a result of the examination.

The examiners determined that certain invoices were not maintained for paid general expenses. According to ALA. CODE § 27-27-30 (1975):

“No insurer shall make any disbursement of \$25.00 or more unless evidenced by a voucher or other document correctly describing the consideration for the payment and support by a check or receipt endorsed or signed by, or on behalf of, the person receiving the money.”

It was noted that the Company reimbursed certain individuals monthly for office rent. There were no invoices from those persons that indicated location, amount, period, etc., for which the expenses were incurred. In addition, there were no invoices, vouchers, federal tax Form 1099s, or detailed documentation supporting the expenses that were reimbursed.

A review of the Annual Statement *Underwriting and Investment Exhibit, Part 3 – Expenses* indicated that the Company had reported \$19,880, on line 2401, as expenses paid to an affiliate for “appraisal.” Further research and discussions with the Company’s CPA determined the amount was paid for title searches. In a written response to the examiners’ inquiries, Mr. Tim Russell, President, indicated that the title searches were done for underwriting purposes only in those counties where automated data was available. The examiners asked why the Company needed to do a title search for underwriting, and if it was necessary, why this practice was not conducted for all policies. No responses were provided for those questions. Consequently, the examiners were unable to determine the purpose for title searches in the underwriting process.

This examination determined that the title search expenses were inappropriately classified. According to the *Instructions for Uniform Classifications of Expenses of Property and Casualty Insurers* of the NAIC’s Annual Statement Instructions, expenses like surveys, credit, moral hazard, character and commercial reports obtained for underwriting purposes are reported under “Surveys and Underwriting Reports.”

Hence, expenses for title searches should be classified under said caption for the purposes of statutory reporting.

It was noted that the Company reported \$17,767, on line 2403, of the *Underwriting and Investment Exhibit, Part 3 - Expenses* as "miscellaneous" expenses. Additional review indicated that \$13,575, was paid for income tax penalties. Payments for federal and foreign income taxes (including penalties for late payments) should be reported in the *Statement of Income* under "Federal and foreign income taxes incurred," in accordance with the NAIC's Annual Statement Instructions.

The above mentioned misclassifications for "appraisal" and "miscellaneous," in the amounts of \$19,880, and \$17,767, respectively, did not affect the balance sheet, and consequently, no changes were made in the financial statements in this report.

Note 13 – Taxes, licenses and fees

\$7,974

The captioned amount is the same as reported by the Company in its *Annual Statement as of December 31, 2002*, but \$7,974 more than the \$-0- amount determined by this examination.

The Company records indicated that the aforementioned amount consisted of employees' FICA, unemployment contributions and other withholdings, which was not in accordance with the NAIC's Annual Statement Instructions. Said instructions require that all payroll taxes and other funds that the Company holds in a fiduciary capacity for others should be reported under *Amounts withheld or retained by company for account of others*. Since the error was a misclassification issue, which will have no effect on the unassigned surplus, no changes were made to the financial statements for the purposes of this examination.

As indicated above, no investment and underwriting taxes, licenses and fees were reported as owed by the Company as of the examination date.

Note 14 – Unearned premiums

\$3,511,497

The captioned amount is the same as reported by the Company in its *Annual Statement as of December 31, 2002*.

A review of Company records indicated that some insurance contracts were written for a period in excess of twelve months. However, adequate records were not

maintained on these contracts in accordance with ALA. CODE § 27-27-29(a) (1975), which states, in pertinent part:

“Every domestic insurer shall have, and maintain, its principal place of business and home office in this state and shall keep therein complete records of its assets, transactions and affairs in accordance with such methods and systems as are customary or suitable as to the kind or kinds, of insurance transacted.”

Company management indicated that there was no separate calculation of unearned premium reserve on policies greater than or equal to thirteen months. According to the guidance provided by *SSAP No 65*, paragraph 23, of the NAIC's Accounting Practices and Procedures Manual, the reporting entity is required to establish an adequate unearned premium reserve, to be reported as the unearned reserve when the following conditions are fulfilled:

- a. The policy or contract term is greater than or equal to 13 months; and
- b. The reporting entity can neither cancel the contract, nor increase the premium during the policy or contract term.”

The three-year contracts written by the Company meet the aforementioned conditions, and reporting requirements of an unearned premium reserve established by *SSAP No. 65*, paragraphs 23-32, of the NAIC's Accounting Practices and Procedures Manual. The review of Company records indicated that uncollected deferred premiums on the aforementioned contracts were not reported as an asset. Not recording unearned premium reserve on said contracts will have no effect on the Company's surplus; hence, no changes were made to the financial statements for the purposes of the examination.

Note 15 – Advance premium

\$ -0-

The captioned amount is the same as reported by the Company in its *Annual Statement as of December 31, 2002*, but \$50,999 less than the \$50,999 determined by this examination. Due to immateriality, no changes were made to the financial statements for the purposes of the examination.

Company records indicated that 223 policies had been processed prior to the effective date, resulting in advance premium in the amount of \$50,999. The records indicated that a liability for advance premiums had not been recorded in accordance with *SSAP No. 53*, paragraph 13, of the NAIC's Accounting Practices and Procedures Manual, which states:

“Advance premiums result when the policies have been processed, and the premium has been paid prior to the effective date. These advance premiums are reported as a liability in the statutory financial statement and not considered income until due. Such amounts are not included in written premium or the unearned premium reserve.”

The Annual Statement Convention Blank also contains a specific line on the balance sheet for *Advance premium*.

Note 16 – Unassigned funds (surplus) **\$6,417,533**

Unassigned funds (surplus), as determined by this examination, was \$1,874,378 less than the \$8,291,911 amount reported by the Company in its 2002 Annual Statement.

The following schedule presents a reconciliation of the unassigned funds per the Company's filed statement to that developed by this examination:

Unassigned funds (surplus) per Company **\$ 8,291,911**

Examination increase/(decrease) to assets:

• <u>Note 3</u> – Common stocks	\$ (10,368)
• <u>Note 5</u> – Real estate	(859,594)
• <u>Note 6</u> – Cash and short-term investments	(183,267)
• <u>Note 7</u> – Premiums and agents' balances in course of collection	(436,245)
Total increase/(decrease) to assets	<u>\$(1,489,474)</u>

Examination (increase)/decrease to liabilities:

• <u>Note 11</u> – Losses and Loss adjustment expenses	\$ (102,276)
• <u>Note 13</u> – Other expenses	(131,315)
Total (increase)/decrease to liabilities	<u>\$(233,591)</u>

Net Increase/(Decrease) **\$(1,723,065)**

Unassigned funds (surplus) per Examination **\$ 6,568,846**

CONTINGENT LIABILITIES AND PENDING LITIGATION

The review of contingent liabilities and pending litigation included an inspection of representations made by management, a review of a report to the independent CPAs on pending litigation made by Company council, and a general review of the Company's records and files conducted during the examination, including a review of claims. This review did not disclose items that would have a material affect on the Company's financial position in the event of an adverse outcome.

It was noted that the Company did not reserve any funds for legal actions brought against the Company. No reserve had been established for expenses of litigation on lawsuits known to exist at the December 31, 2002 reporting date. Further information concerning DCCE and A&O reserving may be found in this report in the NOTES TO FINANCIAL STATEMENTS section under "Note 10 - Losses and Loss adjustment expenses."

As was noted previously in the MARKET CONDUCT ACTIVITIES section, under the *Producer Licensing* caption, two of the Company's agents (who were also directors) were not appointed as producers in accordance with ALA. CODE § 27-7-4(b) (1975). These persons produced a total of \$3,364,620 in premiums during the five-year examination period. In accordance with ALA. CODE § Section 27-7-4(a) (1975), the Company is contingently liable for a fine of up to three time the premium received, or \$10,093,860 [$\$3,364,620 * 3$]. Commissions were paid to these individuals on business produced during those years in which they were not appointed. Commissions should be paid only to those producers who are licensed and appointed in accordance with ALA. CODE §§ 27-7-4 and 27-7-30 (1975). ALA. CODE § 27-7-4.1(b) (1975) stipulates that an insurer or producer violating said sections "shall be liable for a fine in an amount of up to three times the amount of the commission paid." Based on documentation evidencing \$636,944 in paid commissions as of the December 31, 2002 examination date, the Company would be contingently liable for a fine of as much as \$1,910,832 [$\$636,944 * 3$].

COMPLIANCE WITH PREVIOUS RECOMMENDATIONS

A review was conducted during the current examination with regard to the Company's compliance with the recommendations made in the previous examination report. This review indicated that the Company had satisfactorily complied with the prior recommendations with the exception of certain items listed below.

Holding Company and Affiliate Matters - Transactions and Agreements with Affiliates:

Service agreements - The prior examination recommended that the Company perform an analysis to determine that the services provided by the affiliated Gulf Coast Title Insurance Company were fair and reasonable in accordance with ALA. CODE § 27-29-5(a)(1) (1975). This examination noted that the Company had not complied with the recommendations made in the prior examination.

The prior examination recommended that the aforementioned arrangements between affiliates be filed on a Form B for approval in accordance with ALA. CODE § 27-29-4(b)(3) (1975), and ALDOI *Regulation No. 55*. The Company could not provide evidence that the agreements were approved by the commissioner of the ALDOI; hence, the Company had not complied with the recommendations made in the prior examination.

Employee and Agent Welfare – Deferred Compensation Agreement – The previous examination report recommended that “the Company designated the individual deferred compensation investments as restricted on the appropriate schedule(s) of future Annual Statements in accordance with the NAIC’s Annual Statement Instructions.” The Company did not comply with this recommendation.

Accounts and Records – The previous examination report recommended that the Company retain an independent CPA firm in accordance with NAIC’s Annual Statement Instructions and ALDOI *Regulation No. 100*. The Company did not comply with this recommendation.

It was also recommended that the Company complete its Annual Statement in accordance with NAIC instructions and ALDOI *Regulation No. 97*. The Company did not comply with this recommendation in its entirety.

Bonds, Preferred stocks, common stocks, cash and short-term investments – It was recommended in the previous examination that the Company maintain its assets in the State of Alabama in compliance with ALA. CODE §§ 27-3-11(e), 27-27-29 (b), and 27-37-1 (1975). The Company has not complied with this recommendation.

It was also recommended that the Company maintain approved custodial agreements with all entities holding its securities in accordance with ALDOI *Regulation No. 77*. At December 31, 2002, the Company had not complied; however, subsequent to the examination date, the Company obtained approval of its custodial agreement from the ALDOI on October 20, 2003.

It was further recommended that if the Company chooses to leave or place securities in institutions not operating under signed, approved custodial agreements, then said securities should be not admitted in all future filings with the ALDOI. The Company had not complied with this recommendation.

It was also recommended that the Company file SAR reports on and value all of its security acquisitions in accordance with the NAIC's Security Valuation Office's Purposes and Procedures Manual, the Valuation of Securities Manual, and ALDOI *Regulation No. 98*. The Company did not comply with this recommendation.

It was also recommended that the Company classify its investments and complete the various schedules in accordance with the NAIC's Annual Statement Instructions. The Company did not comply with this recommendation.

Real estate – The previous examination recommended that the Company obtain appraisals on its real properties in order to value them in accordance with ALA. CODE § 27-37-7(b) (1975). The Company did not comply with this recommendation.

Losses – The previous examination report recommend that the Company analyze and appropriately book ceded incurred-but-not-reported (IBNR) reserves in future Annual Statements.

It was also recommended that the Company reasonably designate loss and allocated loss adjustment expense (ALAE) reserve to their respective components rather than book the entire amount as loss reserves.

In addition, it was recommended that the Company reasonably estimate and book unallocated loss adjustment expense (ULAE) reserves in future Annual Statements.

The Company did not comply with any of these recommendations. In the current examination, the examiners are making similar recommendations but in a more generalized manner. Specifically, the current recommendation is that the Company use appropriate actuarial methods to calculate loss reserves and LAE reserves booked in future Annual Statements. All of the above recommendations are implicit within that recommendation. It should be noted that references to ALAE and ULAE in the prior exam apply now to DCCE and A&O reserves.

Federal and foreign income taxes - The previous examination report recommended that the Company follow the representations made in its Form B filing and settle all intercompany balances annually in the first quarter of the year.

The Company did not comply with this recommendation.

All of these recommendations are restated in the following COMMENTS AND RECOMMENDATIONS section of this report, under the specific captions to which they pertain.

COMMENTS AND RECOMMENDATIONS

The following summary presents the comments and recommendations that are made in the current *Report of Examination*.

Management and Control:

Board of Directors – Page 3

It is recommended that the Company document the presentation of its audit report in the Board of Directors minutes in accordance with Article VII of its By-Laws.

Officers – Page 5

It is recommended that the Company's Board of Directors elect its officers in kind and number in accordance with its By-Laws.

Management Contract – Page 5

It is recommended that the Company cease making payments of annual bonuses and commissions to its officers and/or directors, in compliance with the Commissioner's *Order*, dated September 20, 2000, and ALA. CODE § 27-27-26(a) (1975), which do not permit such remuneration.

Conflict of Interest – Page 7

It is recommended that conflicts or potential conflicts of interest be disclosed in the Company's Annual Statements in accordance with the NAIC's Annual Statement Instructions and the relevant parts of ALA. CODE § 10-2B-8.60 (1975).

Holding Company and Affiliate Matters:

Transactions and Agreements with Affiliates – Page 9

It is recommended that the Company perform or obtain cost and services received analysis with regard to various management, operating and service agreements in effect with its affiliated companies, to determine that the services received are fair and reasonable in compliance with ALA. CODE § 27-29-5(a)(1) (1975). In addition, **it is recommended** that any agreements which are not determined to be fair and

reasonable, be obtained from outside sources or discontinued, if deemed to be not necessary. This recommendation was also made in the previous examination report.

It is further recommended that the Company review any future invoices received to determine that the charges are rendered in accordance with the terms and conditions of the agreement(s), and that the disbursement is in compliance with ALA. CODE § 27-27-30 (1975), which requires a voucher and supporting documentation to evidence any disbursement of \$25 or more. This recommendation was also made in the previous examination report.

It is recommended that the Company obtain written agreements to substantiate the relationships in effect under which the Company provides services and facilities to, or receives services and the use of facilities from, the various affiliated parties in the Holding Company System. Item (4) of the aforementioned section of the *Alabama Insurance Code* requires that the records between the parties be maintained so as "to clearly and accurately disclose the precise nature and details of the transactions." This recommendation was also made in the previous examination report.

It is recommended that the Company file all current and prospective agreements with affiliated companies in accordance with ALA. CODE § 27-29-5(b) (1975), which requires filing with and approval from the Alabama Insurance Commissioner prior to entering into any such transaction. This recommendation was also made in the previous examination report.

Fidelity Bond and Other Insurance – Page 12

It is recommended that management disclose to its reinsurers that the Company is issuing policies on property that it owns.

Employee and Agents' Welfare – Page 13

It is recommended that the Company annotate its Annual Statement schedules with the appropriate symbol to indicate that investments included in its benefit plans are restricted, and so designated, and complete the relevant areas of the *Notes to Financial Statements* and *General Interrogatories* in accordance with the NAIC's Annual Statement Instructions and guidelines thereto. It was noted that a similar recommendation was made in the previous examination report.

It is also recommended that the Company maintain its benefit plan assets in

accordance with *SSAP No. 8*, (Pensions), and *SSAP No. 14*, (Postretirement Benefits Other Than Pensions), of the NAIC's Accounting Practices and Procedures Manual.

Section 1033 of Title 18 of the US Code – Page 15

It is recommended that the Company maintain documentation that demonstrates its employees are not in conflict with Section 1033 of Title 18 of the US Code and ALA. ADMIN CODE 482-1-121 (2003), *Procedures Governing Persons Subject To 18 U.S. Code §1033*, which prohibit certain persons from participating in the business of insurance.

Market Conduct Activities:

Company Operations/Management – Page 17

Antifraud Plan and Implementation – Page 17

It is recommended that the Company have antifraud initiatives in place to detect, prosecute and prevent fraudulent insurance acts as suggested by Company Operations/Management Standard 3, of the NAIC's Market Conduct Examiners Handbook.

Record Adequacy – Page 17

It is recommended that the Company maintain its policy files in accordance with ALA. CODE § 27-27-29 (1975), which requires an insurer to maintain complete records of its insurance transactions and affairs.

Record Retention – Page 18

It is recommended that the Company ensure that the documentation in the policy files is complete and maintained in accordance with Section 3, of ALDOI *Regulation No. 118*, which states that a company should maintain all records of its insurance transactions for a retention period of “not less than five (5) years.”

Procedures to Limit Access to Personal Information – Page 18

It is recommended that the Company have specific procedures for the “collection, use and disclosure of information gathered in connection with insurance transactions so as to minimize any improper intrusion into the privacy of applicants and policyholders” as defined in Company Operations/Management Standard 10, of the NAIC's Market Conduct Examiners Handbook.

Complaint Handling – Page 18

Complaint Log and Documentation – Page 19

It is recommended that the Company maintain a complaint log in accordance with Complaint Handling Standard 1 of the NAIC's Market Conduct Examiners Handbook, and ALA. CODE § 27-27-29(a) (1975), which requires that a company maintain all records of its insurance transactions and affairs.

Complaint Procedures Manual – Page 19

It is recommended that the Company have written guidelines for complaint procedures to ensure that complaints are satisfactorily distributed, recorded and responded to, and communicate this to policyholders as defined by Complaint Handling Standard 2, of the NAIC's Market Conduct Examiners Handbook.

Complaint Documentation – Page 19

It is recommended that the Company keep complete records as required by ALA. CODE § 27-27-29(a) (1975), for responses to complaints received from consumers.

It is recommended that the Company maintain records that evidence the finalization and disposition of complaints, as required by Complaint Handling Standard 3, of the NAIC's Market Conduct Examiners Handbook, and the Company's replies to the ALDOI within the 10-day time frame, in accordance with ALDOI *Regulation No. 118*.

Response Time – Page 20

It is recommended that the Company keep adequate documentation and respond to complaints in accordance with ALDOI *Regulation No. 118*, and Complaint Handling Standard 4, of the NAIC's Market Conduct Examiners Handbook.

Marketing and Sales – Page 20

Control of Advertising Content, Form and Dissemination – Page 20

It is recommended that the Company execute written contracts between itself and its producers in order to ensure that the producers follow the standards set forth by the Company, including advertising, and adhere to guidelines established by the NAIC's Market Conduct Examiners Handbook, thereby allowing the Company an avenue in which to monitor its producers.

Advertising File – Page 20

It is recommended that the Company maintain its advertising file in accordance with Section 20.B., of ALDOI *Regulation No. 13*.

Advertising *Certificate of Compliance* – Page 21

It is recommended that the Company file an advertising *Certificate of Compliance* with its Annual Statement in compliance with Section 20.C., of ALDOI *Regulation No. 13*.

Producer Licensing – Page 21

Producer licenses and appointments – Page 21

It is recommended that the Company license and appoint producers in accordance with ALA. CODE § 27-7-4(a) (1975), which requires a person selling insurance to be licensed for that line of authority, and ALA. CODE § 27-7-30(a) (1975), which requires each insurer appointing a producer to file a notice of appointment with the Commissioner.

Procedures for appointment – Page 22

It is recommended that the Company implement and maintain procedures pursuant to guidelines defined in Producer Licensing Standards of the NAIC's Market Conduct Examiners Handbook to ensure that producers are properly licensed and appointed. These procedures would also help the Company to monitor its compliance with ALA. CODE §§ 27-7-4, and 27-7-30 (1975).

File documentation – Page 22

It is recommended that the Company maintain complete producer records and correct information in its hard copy and computer data files as defined by ALA. CODE § 27-27-29(a) (1975), and Producer Licensing Standards 1 and 2, of the NAIC's Market Conduct Examiners Handbook.

Business Produced by Officers and/or Directors Not Appointed by the Company as Agents – Page 22

It is recommended that the Company accept business from only those persons who are both licensed and appointed in accordance with ALA. CODE § 27-7-4(a) (1975). The Company is reminded that if business is accepted from persons not licensed and appointed, the Company will be liable for a fine of up to three times the premium received from that person in accordance with the aforementioned section of the *Alabama Insurance Code*.

It is recommended that the Company appoint its producers in accordance with ALA. CODE § 27-7-30 (1975).

Commission Payments to Officers or Directors – Page 23

It is recommended that the Company cease paying commission to its officers, directors and/or committee members in accordance with ALA. CODE § 27-27-26

(1975), and the ALDOI Bulletin, dated February 11, 1992, concerning this pecuniary interest statute.

Commission Payments to Officers and/or Directors not Licensed and Appointed – Page 24

It is recommended that the Company pay commissions to only those producers who are licensed and appointed in accordance with ALA. CODE §§ 27-7-4 and 27-7-30 (1975). The Company is reminded that if commissions are paid in violation of these sections, ALA. CODE § 27-7-4.1(b) (1975) provides that the insurer would be liable for a fine in an amount of up to three times the amount of the commission paid.

Underwriting and Rating – Page 25

***File Documentation* – Page 25**

It is recommended that the Company maintain complete records of its underwriting transactions in compliance with ALA. CODE § 27-27-29 (1975), which requires the maintenance of insurance transaction records, the Company's underwriting guidelines, and Underwriting and Rating Standard 15, of the NAIC's Market Conduct Examiners Handbook, which stipulates that file documentation should be maintained in order to adequately support decisions made.

***Premium refunds* – Page 26**

It was noted that the agents' manual stated that a minimum premium of \$25 will be retained by the Company. Since there is no provision in ALA. CODE § 27-36-3 (1975) [*Unearned premium reserves: property, casualty, and surety insurance*] that permits the Company to retain a minimum of the premium, **it is recommended** that the Company refund the full amount of premium due to the insured.

Claims – Page 26

***Denied and closed-without-payment claims* – Page 27**

It is recommended that the Company maintain claims records in accordance with ALDOI Regulation No. 118, Section 3, which states that an insurer shall maintain its books, records and documents to readily ascertain the Company's financial condition, and ALA. CODE § 27-27-29 (1975), which states that "every domestic insurer shall have, and maintain...complete records of its assets, transactions and affairs..."

It is also recommended that the Company comply with ALA. ADMIN CODE 482-1-125-.04 (2003), which states that an "insurer shall maintain claim files that are "accessible and retrievable for an examination" in order to conduct a proper examination on the basis for all closed without payment claims.

Notices of Claim Denials to Policyholders – Page 27

It is recommended that the Company maintain claims records in accordance with ALDOI Regulation No. 118, Section 3 which requires an insurer to maintain its records in order to make a determination on the financial condition of the Company.

In order to determine the basis for all denied claims, **it is recommended** that the Company comply with Section (a) of ALA. ADMIN CODE 482-1-125-.04 (2003), which states that “the insurer shall maintain claim files that are accessible and retrievable for examination.”

Privacy Policies and Practices – Page 27

Procedures to Limit Access to Personal Information – Page 28

It is recommended that the Company institute specific procedures for the “collection, use and disclosure of information gathered in connection with insurance transactions so as to minimize any improper intrusion into the privacy of applicants and policyholders” as defined in Company Operations/Management Standard 10, of the NAIC’s Market Conduct Examiners Handbook.

Opt Out Method for Disclosure of Nonpublic Personal Financial Information – Page 28

It is recommended that the Company provide a reasonable means for a consumer to exercise the opt out method of disclosure of nonpublic personal financial information in accordance with the options defined in item A.(2)(b), *Examples, Reasonable opt out means*, of ALA. ADMIN CODE 482-1-122-.08 (2002).

Accounts and Records – Page 31

It is recommended that the Company maintain its records in accordance with ALA. CODE § 27-27-29(a) (1975), which states:

“Every domestic insurer shall have, and maintain, its principal place of business and home office in this state and shall keep therein complete records of its assets, transactions and affairs in accordance with such methods and systems as are customary or suitable as to the kind, or kinds, of insurance transacted.”

It is recommended that the Company rotate its engagement partner in accordance with ALDOI Regulation No. 100, which requires that the partner or person responsible

for rendering the annual audit report not act in that capacity for more than seven consecutive years. This recommendation was also made in the previous examination report.

It is also recommended that, concerning the appointment of CPAs for the annual audit, the Company adhere to Article VII, item 1.A., of its By-Laws, which states that "The same individual or firm shall not be employed for any two successive years."

It is recommended that the CPA firm engaged to perform the Company's annual financial audit demonstrate independence and not perform other accounting functions for the Company, including, but not limited to, supervision of the accounting operations, preparation of monthly financial statements, and the compilation of Quarterly and Annual Statements.

In order to readily ascertain the Company's financial condition, **it is recommended** that the Company backup its electronic files and maintain the archived information as of year-end so that it is easily retrievable, and available for review by the ALDOI, in accordance with ALA. CODE § 27-27-29(a) (1975), and ALDOI *Regulation No. 118*.

Bonds – Page 39

It is recommended that the Company use the scientific interest method to calculate the amortization of its bonds in accordance with *SSAP No. 26*, of the NAIC's Accounting Practices and Procedures Manual.

Preferred stocks – Page 39

It is recommended that the Company appropriately classify and report its securities in accordance with the NAIC's Security Valuation Office's Valuations of Securities database and the Purposes and Procedures Manual instructions. Security acquisitions should be filed in accordance with the relevant sections of the Security Valuation Office's Purposes and Procedures Manual.

Common stocks – Page 40

It is recommended that the Company maintain its stocks within the State of Alabama in accordance with ALA. CODE § 27-27-29(b) (1975).

It is recommended that the Company retain complete records of all transactions in accordance with ALA. CODE § 27-27-29(a) (1975).

It is recommended that, if the Company purchases an issue of stock more than once during the year, then the last date of acquisition should be recorded on *Schedule D – Part 3*, of the Annual Statement, in accordance with the NAIC instructions thereto.

It was noted that the Company maintained a margin account, which allowed the Company to purchase securities by borrowing funds up to the amount held in the account. **It is recommended** that the Company refrain from utilizing the account in this manner as by doing so, the Company is exposed to undue risk.

Mortgage loans on real estate – Page 41

It is recommended that the Company not make single dwelling mortgage loans in excess of 80 percent of fair value in accordance with ALA. CODE § 27-41-29(1) (1975).

It is also recommended that the Company insure that real estate loans do not “exceed 75 percent of the fair value of the real estate or leasehold” in accordance with the same section of the *Alabama Insurance Code*.

It is recommended that if an item cannot be specifically identified as an admitted asset, it should be not admitted in accordance with *SSAP No. 4*, of the NAIC’s Accounting Practices and Procedures Manual.

It is recommended that the Company not admit interest from mortgage loans that has accrued for more than 180 days in accordance with *SSAP No. 37*, paragraph 14, of the NAIC’s Accounting Practices and Procedures Manual.

It is recommended that the Company not capitalize past due interest that has accrued for more than 180 days in accordance with *SSAP No. 37*, paragraph 14, of the NAIC’s Accounting Practices and Procedures Manual.

Real estate – Page 42

It is recommended that the Company obtain appraisals for all admitted real estate properties in accordance with *SSAP No. 40*, of the NAIC’s Accounting Practices and

Procedures Manual, and ALA. CODE § 27-37-7(b) (1975). A similar recommendation was also made in the previous examination.

It is recommended that the Company:

- (1) attempt to obtain a permitted practice from the ALDOI in order to amortize the difference between the \$2,303,000 (1993 market value) and \$978,616 (2001 depreciated cost) over a five-year period, and then carry the property at depreciated cost from that point forward; or
- (2) reduce the property to depreciated cost in its next financial statement filed with the ALDOI, so as to be in accordance with *SSAP No. 40*, of the NAIC's Accounting Practices and Procedures Manual (Codification), as adopted by ALDOI *Regulation No. 97*, and the NAIC's Annual Statement Instructions.

Cash and short-term investments – Page 44

It is recommended that the Company maintain its assets in the State of Alabama in accordance with ALA. CODE § 27-27-29(b) (1975).

It is recommended that the Company ensure the collateral pledged for the repurchase agreement meets the requirements of *SSAP No. 45*, of the NAIC's Accounting Practices and Procedures Manual by equaling 102 percent of the purchase price of the underlying security.

It is recommended that the Company report its repurchase agreement transactions under the "Investment" section of the *General Interrogatories* as required by the NAIC's Annual Statement Instructions.

It is recommended that the Company report the repurchase agreement held with Colonial Bank as a short-term investment as required by the NAIC's Annual Statement Instructions and *SSAP No. 2*, of the NAIC's Accounting Practices and Procedures Manual.

Premiums and agents' balances in course of collection – Page 46

It is recommended that if the Company desires to allow its insured an installment option, then the installment option should be addressed by the policy provisions.

It is recommended that the Company age installment premiums in accordance with the contractual due date of the installment, and uncollected premium balances, which are over 90 days, should be not admitted in accordance with *SSAP No. 6*, of the NAIC's Accounting Practices and Procedures Manual.

It is recommended that the Company include all key aging elements, such as policy term or expiration date, in order to verify the accuracy of the aged balances, in accordance with ALA. CODE § 27-27-29(a) (1975), which requires the maintenance of all assets, transactions and affairs. Since all the accounts and records are entered into the computer system, the Company should maintain the same in electronic format for all future audits.

It is recommended that the Company report installments booked and commission payable in accordance with the NAIC's Annual Statement Instructions.

Federal and foreign income tax recoverable and interest thereon - Page 47

It is recommended that the Company include deferred tax assets and liabilities on the balance sheet in accordance with *SSAP No. 10*, paragraphs 5-7, of the NAIC's Accounting Practices and Procedures Manual and Annual Statement Instructions.

Aggregate write-ins for other than invested assets – Page 48

It is recommended that, for all future statutory reporting, the Company not admit the Cash Surrender Value of those policies in which the Company is not the owner and the beneficiary, in accordance with the guidance provided by *SSAP No. 21*, paragraph 5, of the NAIC's Accounting Practices and Procedures Manual.

It is recommended that the Company follow the guidance provided by *SSAP No. 4*, of the NAIC's Accounting Practices and Procedures Manual, and record in the balance sheet only those transactions which meet the definition of an asset. Any asset that does not meet such definition should be charged to operations in the period the transaction occurs.

It is also recommended that the Company follow the guidance provided by *SSAP No. 5*, of the NAIC's Accounting Practices and Procedures Manual, when it has information that assets have been impaired. Impaired assets should be recorded by a charge to operations in accordance with this SSAP.

Losses and Loss adjustment expenses – Page 50

Preparation of Annual Statement Schedule P – Page 55

It is recommended that the Company prepare its Annual Statement *Schedule P* in accordance with the NAIC's instructions thereto, including but not limited to:

- reflecting reinsurance recoverable on paid losses reflected in net paid losses, not ceded case loss reserves;
- booking paid independent adjuster expenses as A&O, not DCCE;
- appropriate inclusion of general expenses and internal claims adjuster expense payments in either DCCE or A&O;
- allocation of bulk and IBNR reserves to the loss and DCCE components as opposed to loss reserves; and
- the booking of A&O reserves.

Reasonableness of established liabilities – Page 55

It was noted that booked net loss and LAE reserves were outside a reasonable range, with most of the deficiency in LAE reserves. Therefore, the actuarial examiners recommend no adjustment to net loss reserves of \$406,199.

It is recommended, however, that net LAE reserves be increased from \$14,525 to \$116,801, in accordance with *SSAP No's 5 and 55*, of the NAIC's Accounting Practices and Procedures Manual.

Similarly, **it is recommended** that adjustments to direct and assumed loss and LAE reserves be booked in *Schedule P*. Specifically, booked loss reserves of \$396,000 should be increased by \$25,000, to \$421,000. LAE reserves should be adjusted from \$14,000 to \$125,000, an increase of \$111,000.

DCCE and A&O expenses – Page 55

It is recommended that reserves be set for all incurred claims as of the accounting date, whether reported or unreported as of that date, in accordance with *SSAP No. 55*, paragraph 5, of the NAIC's Accounting Practices and Procedures Manual.

Further, **it is recommended** that the Company correctly categorize LAE reserves in to DCCE versus A&O components within the Annual Statement in accordance with the above mentioned SSAP and the NAIC's instructions thereto.

Establish liability using actuarial standards – Page 56

It is recommended that the Company establish its LAE liability using appropriate actuarial standards in accordance with *SSAP No. 55*, paragraph 8, of the NAIC's

Accounting Practices and Procedures Manual.

Maintenance of claims records – Page 56

It is recommended that the Company maintain complete records of its loss and LAE transactions, including those pertaining to claims in accordance ALA. CODE § 27-27-29 (1975), and ALDOI *Regulation No. 118*, which require that the Company maintain complete records of its transactions, affairs, books, documents and other business records for no less than five years. The maintenance of records in a computer-based format would constitute a good business practice; however, in accordance with Section 4 of the aforementioned regulation, all records must be capable of duplication to hard copy upon the request of an examiner.

Reserve test work – Page 57

It is recommended that the Company maintain complete records of its claims transactions as required by ALA. CODE § 27-27-29(1975), and ALDOI *Regulation No. 118*.

Presentation and allocation of loss expenses (SSAP No. 70) – Page 57

It is recommended that the Company book its LAE payments and reserves in strict accordance with *SSAP No. 70*, of the NAIC's Accounting Practices and Procedures Manual.

Commissions payable, contingent commissions, and other similar charges – Page 58

It is recommended that the Company report commissions on deferred installment premiums in accordance with the NAIC's Annual Statement Instructions.

Other expenses – Page 59

It is recommended that the Company record liabilities arising from economic benefit received in accordance with *SSAP No. 5*, of the NAIC's Accounting Practices and Procedures Manual, and establish adequate accruals for other expenses in its financial statements in accordance with the NAIC's Annual Statement Instructions.

It is recommended that the Company maintain vouchers for all disbursements of \$25 or more, in accordance with ALA. CODE § 27-27-30 (1975).

It is recommended that the Company prepare and maintain appropriate documentation to evidence the payment of reimbursed office expenses. It is noted that the Company did not report these payments to the Internal Revenue Service on Federal tax Form 1099.

It is recommended that the Company report all expenses incurred for title searches in the *Underwriting and Investment Exhibit, Part 3 – Expenses*, under the “Surveys and Underwriting Reports” caption in accordance with the NAIC’s Annual Statement Instructions.

It is recommended that the Company explain the purpose of the title searches in the underwriting process and why the searches are not conducted for all policies. **It is also recommended** that the Company respond to all inquiries from the examiners in accordance with ALDOI *Regulation No. 118*.

It is recommended that the Company report federal and foreign income taxes incurred (including penalties) in the *Statement of Income* as “Federal and foreign income taxes incurred,” in accordance with the NAIC’s Annual Statement Instructions.

Taxes, licenses and fees – Page 60

It is recommended that the payroll taxes and other funds held by the Company in a fiduciary capacity for others be reported in accordance with the NAIC’s Annual Statement Instructions under *Amount withheld or retained by company for account of others* on the balance sheet.

Unearned premiums – Page 60

It is recommended that the Company maintain complete records of contracts with contract terms greater than or equal to 13 months, in accordance with ALA. CODE § 27-27-29(a) (1975), and calculate the unearned premium reserve in accordance with *SSAP No. 65*, paragraph 23, of the NAIC’s Accounting Practices and Procedures Manual.

Advance premium – Page 61

It is recommended that the Company report premiums received in advance as a liability in the statutory financial statement and not consider the income until due in accordance with *SSAP No. 53*, of the NAIC’s Accounting Practices and Procedures Manual and Annual Statement Instructions.

Compliance with ALDOI Regulation No. 60

It is recommended that the Company file future Annual Statements in accordance with the last filed report of examination pursuant to ALDOI Regulation No. 60.

SUBSEQUENT EVENTS

Custody Agreement

As was noted previously in "Note 1 – Bonds," of the NOTES TO FINANCIAL STATEMENTS section of this report, at the December 31, 2002 examination date, the Company did not maintain an approved custodial agreement in accordance with ALA. ADMIN. CODE 482-1-077 (2003). However, on October 20, 2003, the Company obtained approval of its *Custody Agreement* with The Trust Company of Sterne Agee Leach, from the Commissioner of the ALDOI.


CONCLUSION

Acknowledgement is hereby made of the courteous cooperation extended by the officers and employees of the Company during the course of this examination.

The customary insurance examination procedures, as recommended by the National Association of Insurance Commissioners, have been followed to the extent appropriate in connection with the verification and evaluation of assets and determination of liabilities set forth in this report.

In addition to the undersigned, F. Blase Abreo, CFE, Thomas Dan Norton and Angeline Wages, Examiners; and Randall Ross, FCAS, MAAA, Consulting Actuarial Examiner, all representing the Alabama Department of Insurance, participated in this examination of *Baldwin Mutual Insurance Company, Incorporated*.

Respectfully submitted,

A handwritten signature in dark ink, appearing to read "Anne L. Ward", is written over a horizontal line.

Anne L. Ward, AFE
Examiner-in-Charge
State of Alabama
Department of Insurance

November 3, 2004